PROBLEMS IN FISCAL AND MONETARY POLICY

By The Same Author

Planning in Underdeveloped Countries

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Nepal's Economic Development on International Basis

Economic Development of Nepal

Agricultural Development in Nepal

In Collaboration with Dr. S. C. Jain

PROBLEMS IN FISCAL AND MONETARY POLICY

A CASE STUDY OF NEPAL

by

Y. P. PANT

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SAHAYOGI PRAKASHAN
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DEDICATED TO ALL
WHO ARE DEDICATING THEMSELVES
TO THE ECONOMIC ADVANCEMENT OF NEPAL

PREFACE

It was participating in the Third Rehovoth Conference in August 1965 at Jerusalem which instigated me to make this study on the fiscal and monetary problems. The Conference was sponsored by the Continuation Committee (of which I am one of the members), in co-operation with the Eliezer Kaplan School of Economics and Social Sciences in the University of Jerusalem, the Bank of Israel and the Weitzman Institute of Science. After having discussed a number of problems of developing countries with renowned international experts, I was all the more encouraged to write this book and present Nepal in this setting to the international world, particularly in the context of my close association with the problems of growth of this country for almost the last decade.

The main object of this study is to focus the basic problems of mobilising adequate and real financial resources, of course within certain limitations under the existing conditions, for rapid economic development in a country like Nepal, which was almost a sealed letter to the outside world until 1950. In the first instance, I have attempted to analyse the problems in fiscal and monetary aspects of the country during the past decade and a half and more, after she emerged into the international arena. Such an historical appraisal provides a background for Nepal to place the modern fiscal and monetary problems in proper perspective.

Then with the characteristics of underdevelopment, both in the fiscal and monetary fields, I have tried to explain relevant problems and prospects in Nepal, which has embarked upon a deliberate large-scale planned economic development, of course facing a number of constraints in the process. The greater part of the discussion has been devoted to analysis of the fundamental problems of fiscal policy in developing countries, with particular reference to Nepal. On the basis of the country's experiences in recent years, one can infer that taxation for mobilising domestic resources is the most important source of development finance, both for the direct contribution which it can make, and for its

indirect effects on control and on incentive, and in narrowing the gap in available income within a certain period of time.

With regard to the contribution of monetary policy to economic development in Nepal, I have tried to consider this aspect on the basis of the extended scope of the subject. Monetary policy, as we all know, has over the last century changed its aims and its methods, and has in a variety of ways—though slowly—become integrated with fiscal policy. Today, the Central Bank is not only a lender of last resort; it is increasingly coming to be concerned with the liquidity position of the entire economy and the stability of the price level. However, in a country like Nepal—both from historical and traditional aspects, the non-monetised sector being predominant—the efficacy of central banking and commercial banking policies are strictly limited. As such, I have tried, in the context of existing conditions, to suggest certain measures for improvement. We have still a very long way to go in this direction. However, a critical evaluation of the fiscal and monetary policies in Nepal can itself logically suggest the most appropriate structure for the economy for attaining the economic goals set out in the government official policies; and both fiscal and monetary policies should work closely for accelerating the rate of economic development, which has been very slow on any international standard.

In preparing this study I have been conscious of two types of obligations. First, I have greatly benefited from the works of the renowned economists like Prof. Simon Kuznets, Dr. John K. Galbraith, Dr. Harry G. Johnson and Prof. Nicholas Kaldor, with whom I could have some personal exchange of views also on the basic problems of underdeveloped countries. I owe a special debt to Sir Roy Harrod and Dr. Robert Triffin for the time they gave so generously in discussing the ideas of the study both at the early and later stages. Secondly, I have to record my gratitude to His Majesty's Government of Nepal. My working in various government Ministries and Agencies for a number of years has enabled me to develop a pragmatic approach towards the solution of the country's problems of development, of course against the theoretical background.

I owe a special debt of gratitude to Mr. Christopher Hurst, my publisher, who almost compelled me to complete the study much earlier than I had planned, since he was so much interested in its

early publication. My thanks are also due to Mr. R. D. Pant, who helped considerably in the collection and compilation of statistical tables, to Mrs. Chandika Amatya for supervising the final typing and indexing, and to Mr. Prem Narayan Shrestha for doing the careful job of typing.

However, none of the individuals mentioned above shares the responsibility for the final form of the manuscript, and I am alone responsible for errors that may still remain. Finally, the views expressed in the book are strictly personal and have nothing to do with my official capacity whatsoever.

January, 1970
Kathmandu

Y. P. PANT

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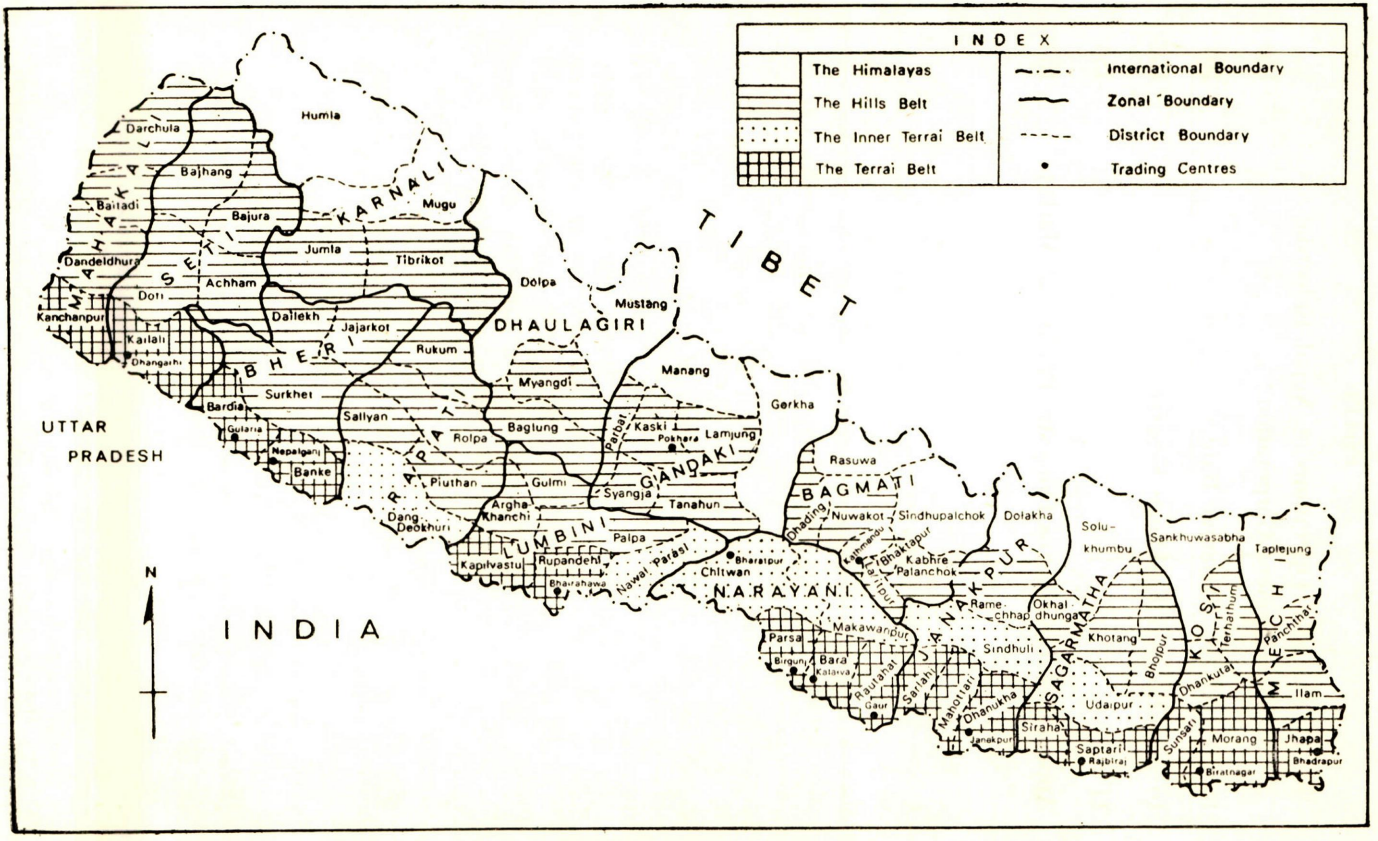
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MAP OF NEPAL

1

INTRODUCTION

TODAY in most countries economic policy is based on acceptance of the fundamental objective that development in the long term should be promoted with stability. In general, a non-inflationary environment is conducive to sustained, continuous and efficient development rather than fitful, uneven and unstable growth. In developing countries both financial and monetary control and direct physical controls have their main difficulties in the context of relatively underdeveloped economic conditions, the presence of a vast number of small producers and consumers and ramified distributive mechanism, and undeveloped administrative organisations. Broadly, financial control encompasses fiscal or government budgetary policies pursued by the Government, and monetary control comprises monetary or general credit policies exercised by the Central Bank. Even in Western European countries, today after a continuous growth of well over 20 years, monetary weapons are being increasingly sharpened in order to arrest the inflationary pressure and ease the strains on the overheated economy.

SAVINGS AND INVESTMENT

The developing countries are characterised by low average levels of per capita income, low enough to raise the question of how the population manages to survive[1] and as such production, with outmoded techniques, is carried on with a relatively small

[1] Simon Kuznets, 'Economic Growth and Income Inequality' in *American Economic Review*, March 1955, p. 21.

amount of real capital per head. Thus it is very difficult for a developing country to get rid of its malignant poverty. Of course, among the underdeveloped countries there are great differences – some are agriculturally prosperous, some possess very advanced civilizations and a traditional heritage, some are densely populated with a considerable amount of surplus labour and others are sparsely populated. However, in general, the vicious circle of poverty, as a matter of practice, constantly works on both the supply and demand sides.[2] Low rates of savings and investment lead to the perpetuation of low incomes. On the demand side, the low rate of productivity and investment is responsible for lowering the purchasing power of the people in real terms. This in turn leads to a low inducement to invest and the future perpetuation of low income.

In such countries, a generally low rate of savings and investment results in the low level of income, i.e. typical developing countries channel less than 10 per cent of their low income into investment every year. For a country like Nepal, the figure has been still much less. A small ratio of investment to national income gives only a small annual rise in national income, and this rise in income is counterbalanced or more than counterbalanced by the annual increases in population, which in Asia is a little more than one per cent.[3] Therefore, under the circumstances, such countries have to develop their economies by resorting to outside resources. Today in many developing countries in Asia and Africa, this policy approach is being adopted on a planned basis.

In addition to mobilising internal resources and promoting private savings and thus ensuring collective savings through taxation, proper implementation of the financial plan and reasonable co-ordination in money terms will have to rely on fiscal and monetary measures. Though all such measures are subordinate to a physical plan, they play an important role in developing

[2] Raja J. Chelliah, *Fiscal Policy in Underdeveloped Countries,* George Allen and Unwin, London, 1960, p. 26.

[3] In recent years various countries are vigorously taking resort to family planning measures. For example, in Nepal the recent objective of family planning has been to reduce the rate of natural increase in population by 0.1% per annum by 1970, the long-term objective being to reduce the rate of natural increase in population from 2% per annum at present to 1% per annum by 1985.

countries, in the gradual process of taking the economy from the subsistence level to the state of self-sustaining economic growth.

FISCAL POLICY AND DEVELOPMENT

Fiscal policy, like any other government policy, derives its meaning and direction from the aspirations and goals of the society within which it operates, of the people whom it serves. Such aspirations relate to economic betterment and stability to provide the material soil within which human dignity and political freedom can grow. The objectives of tax and budgetary policy are to make funds available for economic development, to maintain reasonable economic stability in the face of long-term inflationary pressure and short-run international price movements and also to reduce, where they exist, the extreme inequalities in wealth, income and consumption standards which undermine productive efficiency, and bring about injustice and political instability.

Historically, until after the end of the First World War in most Asian countries, fiscal policy used to be identified with tariff policy. This was the case in India, for example. During almost the last five decades, under the impact of the great Depression and the Second World War, remarkable improvements have taken place and the objective has gone in favour of long-run stability, that is, promoting conditions of stable growth. This is a departure from Keynes' General Theory in which fiscal policy referred to the influence of taxation on savings, and of government investment expenditures financed by loans from the public and looked at as a state policy that used public finance as a balancing factor in the development of the economy.[4] Of course, it is notable that it was under the impact of Depression and the advent of Keynesian economics, after the publication of the *General Theory*, that the scope of public finance was largely changed and the budget was made to serve as an economic regulator.

It is, however, very difficult to draw a line of demarcation between fiscal policy and monetary policy. For example, Prof.

[4] S. E. Harris (Ed.), *New Economics*, Dennis Dobson, London, 1949, pp. 453-54.

Hansen considers that only such government measures as are directly connected with payments to and from the government can be counted as fiscal policy. Since such a wide definition would also cover certain measures which are usually considered monetary policy, using the market criterion, he further explains: "Monetary policy will consist of all those measures directly connected with government transactions in the credit market, and fiscal policy comprises those measures connected with all the other government transactions." Thus, in other words, "fiscal policy has to do with the size of the net national debt, in the most general sense, while monetary policy is a question of the composition of the net national debt."[5] Even then it would be necessary to have some general approach. Prof. Hansen, in this respect, further suggests that we should consider the changes in the amount or means of payments to be a fiscal policy matter in so far as the changes are connected with a fiscal policy transaction, and a monetary policy matter if it is connected with a monetary transaction.[6]

As a matter of fact, many of the factors in relation to fiscal problems come to light in a consideration of the central problem of capital formation. As against in a developed country, where tax policy is used to reduce or offset the fluctuations in the volume of capital formation and the consequent destabilizing influence on the economy as a whole, in a developing country in the context of the extremely low levels of income and savings, producing a vicious circle of poverty, taxation is increasingly assigned a far more positive role in the process of capital formation and technological change. Under the circumstances, government effort is diverted towards maximizing tax resources for productive investment programme. Ideally speaking, formulation of fiscal policy in any country for balanced and non-inflationary development should rest on a foundation of factual knowledge relating not only to national income and such components as private consumption expenditures, private investment and government purchases of goods and services, but also to the flow of resources among the key agricultural, industrial and commercial sectors of the economy. In fact, the vicious circle of extreme

[5] Bent Hansen, *The Economic Theory of Fiscal Policy*, George Allen and Unwin, London, 1958, p. 31.

[6] *Ibid.*, p. 33.

poverty can be broken, apart from foreign aid, through vigorous taxation and government development programmes. Growth plus stability presents a more challenging problem than a merely compensatory fiscal policy.

MONETARY POLICY AND DYNAMIC ELEMENTS

Fiscal policy involves a direct draft on the financial resources and purchasing power in the hands of the public, and with particular classes of producers or consumers, this is effected by the use of a variety of income and commodity taxes; "monetary policy, in contrast, only influences the cost of availability of credit, which cannot be a similarly potent weapon,"[7] particularly in a developing country, in the overall context of the existence of a vast non-monetized sector in the economy. Also the capacity of taxation, for example, to differentiate among the circumstances of different classes of producers and consumers through relief and rebates and investment allowances of various kinds or through commodity taxes is much greater than that of Central Bank action through allocation of bank credit. Thus, the role of monetary policy should be recognised as subsidiary or subordinate to fiscal policy in a developing country. In fact, there has to be a money market before a monetary policy can be effective. Of course, in such countries, with the gradual expansion of the monetized sector, the effective range of monetary policy slowly expands.

At the same time, the potential scope at any stage would depend upon the dynamic elements in the situation, such as the rate of growth of national income, the vitality of fiscal policy under an environment of planned development, and so on. In this respect, fiscal policy has a direct and powerful impact on the income stream, whereas monetary policy influences the income stream only indirectly. For example, in any given situation, monetary expansion alone may not accelerate the growth process. If growth factors are operating, and if, for the promotion of economic activity, there is need for the creation of credit, monetary expansion may have salutary effects on development.

However, the predominance of the non-monetized sector, as

[7] B. K. Madan, 'The Role of Monetary Policy in a Developing Economy', in *Reserve Bank of India Bulletin*, Bombay, 1961.

in Nepal, limits the scope of both fiscal as well as monetary policy. Even under such conditions, the taxation and expenditure policies of the state have started recently to be more pervasive in their effect even on incomes in the unorganised monetary sector than Central Bank actions in the monetary field. Since the monetary economy is not properly organised and integrated, it is not responsive to a great extent to economic stimuli. In more recent years after 1956 an increasing number of financial and development institutions have been set up, and all such institutions are gradually rendering the central banking activities more effective. Recent experiences have, of course, shown that the links between the unorganised and organised sectors are now numerous and growing, as the resources of indigenous bankers and money-lenders are replenished through recourse to banks, and commercial and cooperative banks are extending their operations through an expanding network of branches to all parts of the country. Thus, with the development in the economy, the effective range of monetary policy also seems to be gradually expanding.

In short, the inter-relationship between the fiscal and monetary policies goes on developing with the process of growth in a developing economy. For example, if Government budgetary operations, owing to the size of Government expenditures, more particularly on development programmes, generate strong inflationary pressures, the responsibility of monetary policy does not by any means diminish. In fact, the task of monetary policy is enhanced under the conditions of development, as it has the responsibility of freezing part of the liquidity thus generated.

However, it can be properly construed that budgetary policy and banking policy "are almost inseparable because of the associations of both with the whole process of saving and investment and because of the interconnection between the process and the transformation that we call economic development."[8] For example, inflation which may result from over-lending by banks is also the inevitable outcome of over-borrowing by governments and arises far more commonly for that reason.

Within the working of characteristics of underdevelopment,

[8] A. K. Cairncross, *Factors in Economic Development*, George Allen and Unwin, London, 1962, p. 158.

both in the fields of fiscal and monetary problems, the present study is an attempt to analyse some problems and general prospects in relation to the recent economic developments in Nepal.

NEPAL'S PHYSICAL AND ECONOMIC STRUCTURE

Nepal lies along the southern slopes of the Central Himalayas between 26° 20′ N and longitudes 80° 15′ and 88° 15′ E, and the average breadth of the country is about 110 miles. It has an area of 54,362 square miles, and extends more than 500 miles east to west in the shape of an elongated rectangle. The topography of the country is extremely varied. It is bordered on the north by the Tibet region of China and on the west, south and east by the Indian states of Uttar Pradesh, Bihar and West Bengal. The country has been recently divided into 14 zones and 75 districts with the purpose for having co-ordinated system of administration for development.

Conveniently, there are three divisions of the country, each of which has its own geographical and historical characteristics: (i) the Lower or Southern region; (ii) the Central region or midland of hilly districts and (iii) the Northern or Himalayan region.

The Lower region includes the *tarai* plains and the forest-clad slopes of lower hills up to an altitude of about 4,000 feet. Its width is about 16 miles but in some places it is more than 25 miles. It consists of a strip of land some twenty to thirty miles wide, and forms the southern boundary of the country as it merges into the flat land of the Indo-Gangetic Plain of India. It is an alluvial plain with occasional small islands and pockets of forests of varying extent. The *tarai* covers an area of about 8,000 square miles, or about one-seventh of the country's territory. The climate is tropical and the altitude is estimated to be as high as 1,000 feet above sea level. Beyond the *tarai* the '*Bhabar*' forest rises abruptly and stretches from east to west. This part (6,000 square miles in area) is composed mainly of *sal* trees intermingled with '*Simal*' (silk cotton), with a comparatively slight under-growth of grass and scrub.

The Central region is described as 'a clusterous succession of mountains varying in elevation from 4,000 to 10,000 feet with a temperature from 10-12° (fahrenheit) lower than that of the

plains'.[9] This region comprises the high-lying valleys and central ranges of mountains from 4,000 to 10,000 feet. It includes the Mahabharat range (8,000 feet), which forms, geographically speaking, the front of the big over-thrusted nappes. At places this mountain wall is pierced by the gorges of transverse rivers, including the Karnali, Bheri, Narayani and Sapta Koshi. Between the Mahabharat range and the main Himalayan chain is situated the most populous valley in which Kathmandu, the capital, stands.

The Northern region includes the main Himalayan chain ranging from 10,000 to 29,141 feet high. The average height of this region is more than 15,000 feet, and there is thus perennial snow in the higher altitudes of this region. The Himalayas extend 550 miles from west to east in Nepal, and account for 20 per cent of the total area. The occupations of the inhabitants of this region are only yak-breeding and sheep-rearing. The main range itself is divided by the big transversal rivers into different groups. The famous peaks of the Himalayas, Sagarmatha (Mount Everest, 29,141), Kanchanjungha (28,146), Gosaithan (26,492), and Gaurishanker (23,457), lie in this region.

In the absence of adequate irrigational facilities in the greater parts of the country, the prosperity of most parts of the country both in the *tarai* region as well as in the hilly region has been dependent on the success or failure of the monsoon. Although in the country there are not as wide divergences of rainfall as in India, because of the smallness of the size and peculiar geographical structure of the country, still some differences are discernible in different parts. The annual rainfall between Baharaich (UP), Darbhanga (Bihar), Darjeeling (West Bengal) and Kathmandu have varied between 45.67, 49.81, 126.42 and 55.79 inches respectively.[10] Thus normal rainfall at Kathmandu, other parts of Nepal and nearby stations in India does not vary much. The monsoon rain occurs from June to the beginning of October, and is followed by the cold season from mid-April. The annual rainfall averages 55.60 inches, though the normal rainfall at Kathmandu is only 55.79 inches.

The country, with its wide variation in altitude, has evidently a broad range of climates. The *tarai* and *'Bhabar'*, being just

[9] Quoted in Perceval Landon's *'Nepal'* Vol. I, London, 1928, p. 88.

[10] Figures taken from 'Government of India', *Meteorological Observations,* (Monthly Weather Review).

north of the Tropic of Cancer, have a tropical climate. The temperature varies from 80° – 105° F (maximum in June and minimum in January) in the *tarai* and *'Bhabar'*, while it is below 38° – 80° F in hills and mountains which have a temperate and alpine type of climate.

With a population more than 93 per cent dependent on agriculture for their livelihood, agriculture is the most important industry in the country. It is relevant to give a rough idea of the country's agricultural resources with regard to the land-use and general pattern of production. Out of 1,941,000 hectares of total cultivable land, only two-sevenths are under cultivation at present and the rest of the land is covered by snow, forests and fallow lands. The percentage distribution of total cultivated area among the principal crops is estimated roughly to be as follows: paddy 57.7, maize and millets 27.2, wheat 7.7, oilseeds 4.8, tobacco 0.4, jute 1.6 and others 0.6. The land under wheat, potato, oilseeds and tobacco is generally double cropped. Thus the principal crops are paddy, maize and millets (produced mostly in the hills), wheat, potato and other foodgrains, besides other valuable crops like tobacco, jute and so on. It is generally found that vast tracts in the *tarai* plains are left uncultivated for climatic reasons, though they are otherwise suitable for cultivation. Except in a few cases in the *tarai,* the land is cultivated by small peasant families and as two-thirds of the land belong to big land-owners, most of the cultivators are mere tenants with a subsistence level of existence. In recent years land reform measures have increasingly tended to give incentives to cultivators, and from a longer range there are indications that the agricultural production will be rising in course of time.

The forest resources, accounting for about 30 per cent of the total area, offer the country's most promising foundation for a rapid strengthening of the national economy. So far they have not played any important role in the development of the country's economy, and until quite recently exploitation of the forest resources has been a continuous process. Potential domestic and export markets justify prompt measures for the early and integrated utilisation of these resources.

While there is a general impression that Nepal is rich in minerals, the country's geological structure and the possible minerals have not yet been explored properly. In 1951 only one mine and one quarry were operating. The geological survey was

started in 1952, and later on it was taken over by the United Nations Technical Assistance Administration. The United States, through its International Co-operation Administration, provided a large part of the finances for surveying and exploring the mineral resources. Several long-term mapping projects have been undertaken by the Geological Survey of India. In 1957 the United Nations sent an expert to conduct a general geological survey of minerals. Some deposits like hematite iron, limestone, lignite, lead, coal, copper, gold, ceramic clays, mica and petrol have been identified in various places, and investigations of their extent and quality have been started. More definite indications require large-scale survey programmes. So far, difficulties of transportation have prevented mineral exploitation on any sizeable scale. Nearly all porterage has had to be on foot, the mountain trails being too treacherous for mineral resources to be used. It is expected that development of road transport in future will open up many hitherto inaccessible areas. In fact, the intensive exploration programme carried out over the last seventeen years has brought to light a number of promising deposits.

The very essential requisite of modern development is the availability of cheap motive power, and modern industrialism places a great premium on external sources of power. Of all the sources of power in Nepal, hydroelectric potential, at least in physical terms, is virtually unlimited. Quite a number of rivers stemming from the high Himalayas and flowing southward to the plains of India, provide abundant water supply often with rapid rates of fall, for the generation of electric power in units of all sizes. Since large reserves of good quality coal are lacking, hydroelectric plants promise to be the basic of the country's energy production. Though the two basic conditions for hydroelectric power, namely an abundance of water and great differences of altitude, are present in the country to a favourable extent, the potential hitherto exploited is only about 16,000 Kws. The power potential of the country is estimated at about 83,000,000 Kws. The obstacles to a proper utilisation of these vast resources are, among others, non-existence of transport facilities in most of the regions and lack of proper co-ordination on the part of His Majesty's Government regarding their utilisation.

The most important resources of any country are its people, and ultimately they are its only source for the various phases of

development. According to the first scientific census of 1952-54, Nepal was estimated to have a population of 8.4 million with a density of 152 persons per square mile. The census results showed that 71 per cent of the population lived in the hilly regions, which comprised 83 per cent of the total area, and 29 per cent lived in the lowlands of the *tarai*.[11]

The results of the population Census of May 1961 throw more comprehensive light on the demographic trends. According to the figures of that Census, the population of the country is estimated to be 9.4 million and the density of population 174 per square mile.

Against this background, if one looks at the country's economic position today, it presents the classic frame-work of an underdeveloped economy—lack of finance and technological process, agricultural and industrial backwardness and low agricultural productivity. In the century between 1846 and 1951 under the Rana regime, progress—whether economic or political—was completely inhibited.

Even in spite of certain co-ordinated efforts towards the development of the country and raising the standard of living of the masses initiated after 1951, the basic structure has remained more or less the same, and the living standard of the people is among the lowest in the world. The experiences with economic development during the last thirteen years have of course yielded increasing evidence of new influences which, in time, may have a cumulative impact. Contacts with other countries and people are being expanded through diplomatic and good-will missions and the inflow of scholars and tourists. Internally, Government officers are increasingly making tours in different parts and getting acquainted with basic problems of the country. All these have combined to produce a desire for change and progress. Obviously, it will be quite a number of years and after working hard in the various fields of economic activity, before the country will be able to attain a significant rate of progress compared to other developing countries of the world.

[11] Department of Statistics, *Census of Population, Nepal, 1952-54*, Kathmandu, 1958, p. 5.

GENERAL LAY-OUT

This study is divided into two parts. Most of the discussion in the first part has been devoted to the analysis of the fundamental problems of fiscal policy in developing countries, with particular reference to experiences in Nepal. However, along with an outline of the processes of the budgetary formulation and implementation only some of the selected problems that are important, particularly those connected with taxation, have received more intensive treatment. The problem of resource mobilisation, which is the important variable for economic growth, has been brought into proper focus. This analysis of the basic features of the Nepalese tax system and policies has been made within the framework of the planned economic development which the country launched in September 1956. Any fiscal policy for a country will depend, in addition to various other factors, on the level of the development that the country has attained and on the long-term social objectives that it has accepted. Therefore, in addition to underlining the fiscal policy in a country for development strategy, while discussing the basic criterion of fiscal policy in Nepal, efforts should be made to raise the rate of savings and increase the level of investment, and that all other considerations should be subordinated to those ends. This is a point which needs to be specifically stressed in the context of our development.

The remainder of the book is developed to introduce the subject of the efficacy of monetary policy in the context of the recent banking developments, in broad outline both from historical and traditional angles. The non-monetised sector being predominant in the country, even with the gradual expansion of the money-economy in more recent years, the efficacy of central banking and commercial banking policies are even now strictly limited. Therefore, certain measures for improvement, on the basis of the working of the existing financial institutions, have been offered at relevant places. The exchange rate as a device, falling between the fiscal and monetary fields for economic growth, has also received some analysis both in retrospect and prospect. Fiscal and monetary policies being closely related to stimulating economic growth in a developing country, some approach has been made finally to strike a balance between these two areas. It is

definite that only such a proper balance could enable the economy to move from a period of transitional stage of underdevelopment to the stage of self-sustaining economic growth, though on a gradual basis. This also includes a summary of the findings and suggestions for improvements in the perspective of the development plans. Although, at each stage, Nepal has been taken as a case study more specifically to clarify the basic issues involved, the analysis has been presented against some theoretical background, and examples from other countries have been taken to illustrate different issues.

It is necessary at this point to mention the basic limitations of the present study. To begin with, the discussion does not aim to be comprehensive. It is centred around only one of the many problems that an underdeveloped economy typically faces. In the second instance, the statistical data and other information presented in many areas are not perfect, and some of them no doubt involve a good deal of judgement, even if there has been some preference for relying on official sources.

PART I

FISCAL ASPECTS

2

THE BUDGETARY ASPECTS

In the post-war years, the role of national budgeting has been increasingly emphasised as an instrument for economic planning and as a means of assessing the probable development in a country over a given period of time. The budget ordinarily means estimates of revenue and expenditure during a specific period, say a year. It should not, of course, be regarded as merely a mathematical exercise. It is, on the contrary, both a financial report and a plan for the future. It is also a post-financial report which reviews the past performance of the financial and economic activities. This means that there is need to establish a close relationship between the plan and the budget. Most outlays provided for in the public sector portion of a development plan must be incorporated into the budget, if the plan is to be carried out. The fixing of targets and goals in a medium-term plan is obviously based on a variety of assumptions regarding the behaviour of the economy. Of course, the scope of the annual plan as reflected in the annual budget should be the same as that of the long-term and medium-term of the plan. In this context the budgetary system is only an instrument, although most significant of plan implementation, since even in the public sector there may be other decision-making and -implementing agencies, such as public enterprises. In any case "from a practical point of view, the conversion of a public development plan into a series of annual budgets is likely to be the most important stage in the planning process."[1]

[1] Albert Waterston, *Development Planning: Lessons of Experience*, Baltimore, 1965, p. 201.

Therefore, one of the most important means the modern state has at its disposal to influence the economy is the budget deficit or surplus which is represented by the difference between income and expenditure in the budget. This is to determine whether the budget works expansively or contractively.[2] Obviously, to perform its role as a financial counterpart of the public sector plan, the budget of any country should, in general, provide not only for planned capital expenditure but also for associated current expenditure of the Government including total revenue, which comprises domestic financial resources in combination with available external financial resources. The magnitude of the increase in revenue that needs to be brought about in a given country will depend, among other things, on the desired scale of current expenditure and the role allotted to the public savings. For example, as will be discussed in one of the following chapters, in a country like Nepal, where public savings are not rising sufficiently and cannot be stimulated to the possible desired extent, government savings will have a greater role to play also in financing development plans.

PREPARATION OF THE BUDGET

In Nepal before 1951, there was no system of modern budgeting, and in 1952 a national budget was prepared and legislated for the first time in the country's history.[3] Since then it has been prepared and legislated every year. Generally speaking, the entire budgetary system in a country can be identified with four phases, i.e., preparation, legislation, execution and evaluation or auditing. These four phases, though distinct, are continuous and interdependent. The first important requirement for the preparation of the budget is the availability of financial data and the compilation of new financial data based on these figures. It is also necessary to have a proper budgetary accounting and reporting system for attaining this objective. Before 1951, the system in operation was antiquated and outmoded. There used to be a number of treasury offices in various districts. However,

[2] Bent Hansen, *The Economic Theory of Fiscal Policy*, George Allen and Unwin, London, 1958, p. 40.

[3] See my article 'Nepal Has a Budget' in *The Economic Weekly*, Bombay, June 6, 1953. pp. 643-646.

the accounts submitted to the *Kumari Chowk,* the Central Treasury Office, were neither classified nor consolidated. The transfer of cash from one treasury to another was known as expenditure and revenue in the accounts of the two respective treasuries. In 1952, after the introduction of the budgetary system, the accounting and the reporting system could not at first be correspondingly changed to conform with the formulation processes. That is why the budget estimates were nearly guess-work for a number of years. In 1958 an additional financial reporting system was introduced, under which all treasury offices had to submit a monthly statement to the Accountant General's Office, which had been started a few years before. Though in this reporting system no provision was made for a cross-verification of the statement, it at least helped in the work of compilation of government revenue and expenditure during a fiscal year by months, and thus provided a basis for the preparation of the budget. In the following year, 1959, a new accounting system was devised which was further revised and improved in 1963. This new accounting system, gradually introduced all over the country, has been facilitating the preparation of the budget by providing the necessary financial data at the appropriate time. One still can not say that most of the data are perfectly accurate, and there is a long way to go in the preparation of a scientific and well co-ordinated annual budget.

BUDGETARY CLASSIFICATION

The second phase is the use of proper budgetary classification. The budget estimates are a huge mass of detail covering every activity of the government and the mass of figures, in order to be intelligible, must be properly classified. In general, budgetary classification facilitates programme formulation, execution and accountability. There are ways in which the budget may be classified, and different countries have adopted different measures to suit their conditions and objectives. However, there are certain general classification techniques which are broadly used. These are classification by sources, collecting agencies and funds on the revenue side, and classification by function, organizational units and objects of expenditure on the expenditure side. In the first Nepalese budget, a certain type of classification was in-

troduced, but in the budget of subsequent years tremendous improvements had to be effected gradually. As a matter of principle, all such frequent changes defeated the very purpose of classification, which should have a great amount of continuity and comparability. Moreover, in the classification of the budget for the fiscal year 1951/52 and the following years, the number of items used was between eighty and ninety. Though it served quite impressively to establish a tight control over expenditure by the Ministry of Finance, it also limited sharply the discretion of government officials responsible for implementing various programmes. In 1963, with a purpose of doing away with all these drawbacks, a new classification scheme was introduced. In this classification system the number of items under objects of expenditure was reduced to nineteen. Very recently, the Economic Classification System in the simplest sense of the term was introduced into the budget. This has been, within the given limitations, briefly analysed in one of the sections of the present chapter.

Another important aspect in the preparation of the budget is the assignment of the budgetary responsibilities on an organisational basis. In other words, the execution as well as the preparation of the budget at all levels of management must be involved. In the first budget a procedural system was introduced, but the need and importance of the new system was not felt and realised at the various levels of management. As a result, the acknowledgement of budgetary responsibilities remained limited only to the Ministry of Finance. Only in recent years after 1960 is the gradual delegation of financial authority and responsibility to the various levels of management by the Ministry of Finance making them more conscious of the budgetary responsibility. This feeling, of course, still remains to be developed much further, depending on conditions and improved circumstances.

THE LEGISLATIVE ASPECT

The legislative system of the budget is broadly based on the constitutional provisions. In Nepal, with the promulgation of the Interim Constitution in 1952, the national budget had to be submitted to the King for approval. In 1959 the First Constitution of the country was promulgated, which provided that the execu-

tive would have to submit a national budget to the legislative assembly for its approval. In 1962 the Second Constitution of Nepal was promulgated, under which the executive has to submit a national budget to the *Rastriya Panchayat* (an elected body) for its approval. After the budget is passed, it is the responsibility of the executive to carry out the terms of the budget, duly preserving the intent of the legislature. Budget execution is traditionally conceived as a matter of financial control. In the beginning, even with the setting up of the Ministry of Finance as early as 1951, no corresponding changes were made in the allied fields of disbursement, accounting and auditing. Slowly and particularly after 1958, improvements started taking place. For example, in 1959, to dispense with the excessively centralised financial control, a new payment procedure was introduced, under which the Finance Ministry could delegate its authority to other Ministries or departments. Similarly, only in 1963 was the double accounting system introduced.

As experience of other countries have shown, the control of public expenditure necessarily starts in the spending Ministries. Broadly speaking, there have been two alternative methods in use, i.e. the pre-audit and the self-accounting systems. The pre-audit system is more suitable in an emerging country where administrators are new and have little experience. Since under this system all disbursements have to be certified in advance, irregularities at all levels can be effectively prevented. Up to 1963, the first system was in operation in Nepal. However, since experience showed that it entailed frustrating delays, particularly in view of geographical distances, and because the slow rate of 'absorptive capacity' in the development process had to be gradually stepped up in the initial years after 1956, a system with a semblance of self-accounting was started in 1963, in which, on a three-monthly basis, the personal responsibility for orderly disbursements have rested with the Secretary of the spending Ministry, who is also called the Chief Accounting Officer. It is the personal responsibility of the Chief Accounting Officer to see that disbursement takes place as directed, and that there is no overdrawing. He has to submit the statement of accounts of the first quarter to the Ministry of Finance before making a request for the third quarter. Unspent balances have to be returned at the end of the year. This has not worked quite satis-

factorily but, in the development context, this facility has helped significantly. It is, however, very important that the relationship between a central budget agency and the operating ministries is properly articulated.

Post-audit is a common feature in all accounting and budgetary systems.[4] For this purpose, the Auditor General's Office created under the Nepalese constitution is fully independent of the executive. He is authorised to check every transaction of the Government to ensure that it is legally and efficiently done, and under the Constitution it is his duty to submit an annual report to the King regarding the legality of all government transactions completed within that year.

Although some efforts were initiated earlier, as the above analysis shows, it was only after 1960 that efforts were really started to integrate these phases, of course within the limited conditions available in the country. However, in general, the basic change in the fiscal field since 1960 had been the great attention and seriousness placed by the Government in implementing its announced budgetary policies, as well as its overall economic plans. Compared to the earlier decades, there has been, in fact, a great step forward with regard to allocating resources through fiscal measures, as against the early experiences when Government policy was not at all oriented to restricting expenditure in the regular part of the budget, even to a possible minimum consistent with administrative efficiency. For example, in the fiscal year 1963/64, for the first time in the country's budgetary history, a substantial cash contribution from current revenue could be generated to be made available for developmental activities, and this has been continued quite consistently.

MAIN SOURCES OF REVENUE

Normally, as the economy of a country develops and its national income goes on growing, increases in tax may occur without much effort, as a result of the interaction of the tax structure and changes in income. However, in a country like Nepal which has very recently started the process of economic development, such increases may not come about by themselves, unless sustained

[4] Ministry of Finance, *Nepal's Finances*, HMG, Kathmandu, 1965, p. 52.

and continuous efforts are made to prune down in time the traditional types of expenditures. This is imperative in view of the fact that the national income does not increase substantially in the beginning, and even if there is some increase, it is only just sufficient to meet the needs of the growing population.

As mentioned in the preceding section, after 1960 in Nepal the fiscal policy of the Government has undergone significant changes. As a result of the persistent efforts made by the Government over recent years to restrain regular expenditure and contribute savings thus generated to development activities, as shown in Table 2:1, the total revenue has been increasing very considerably. That such a budgetary policy is dependent not only on cutting down the Government's regular expenditure to the minimum but also on increasing trend of revenue is evident from the recent trends of the revenue. In addition to new tax measures, more effective tax collections, both direct and indirect, have been made. For instance, between 1951/52 and 1960/61 the revenue increased from Rs. 30.5 million to Rs. 97.4 million, i.e. 22 per cent annual increase on the average, while between 1961/62 to 1969/70 (the figures for 1969/70 being original estimates) it has gone up by more than 400 per cent.

Table 2:1 also shows that the revenue from the traditional three sources has been going up quite fast in recent times, constituting now more than 75 per cent of the total revenue. The underdeveloped nature of the country's economy, the lack of tax-paying habits among the people, the low income of the majority of the population and low efficiency of the administrative machinery to collect progressive taxes, have all been responsible for this. However, the recent figures also reveal that the traditional sources, though contributing substantially, are slowly losing their importance in comparison with other sources. This has been more fully discussed in one of the following chapters. It is notable that in the internal revenue position, the element of progression has been gradually introduced in the taxation policy in close conformity with the aspiration and attitude of the people. For example, the income tax has been made progressive; for example, the highest range of tax rate has increased from 30 per cent for the fiscal year 1963/64 to as much as 55 per cent for the fiscal year 1969/70. This will, other things being equal, help in mobilising a greater percentage of the yield from the upper income levels.

TABLE 2:1

MAIN RESOURCES OF REVENUE IN SELECTED YEARS

(In Millions of Rupees)

	Customs & Excise	*Land Revenue*	*Forest Revenue*	*Total*	*Total Revenue*	*Percentage of Total Revenue*
1952/53	10	13	2	25	38	65.7
1953/54	12	13	2	27	38	71.0
1954/55	29	16	7	52	67	77.6
1959/60	38	26	15	79	87	90.8
1960/61	40	20	12	72	97	74.4
1961/62	39	28	8	75	91	82.3
1962/63	47	53	9	109	129	84.4
1963/64	69	40	16	124	158	78.4
1964/65	97	43	21	161	192	83.8
1965/66	114	45	19	178	216	82.4
1966/67	142	57	16	215	257	84.5
1967/68 Revised Estimates	151	83	22	256	326	78.5
1968/69 Revised Estimates	201	86	20	307	400	76.7
1969/70 Estimates	224	87	20	331	442	74.8

Source: Ministry of Finance, HMG.

The very fact that tax receipts are contributing increasingly to developmental activities is a step towards greater self-reliance, of course within the considerable limits of a developing country.

PUBLIC EXPENDITURE FOR DEVELOPMENT

Apart from resource mobilization, the expenditure programme of the Government also forms an integral part of fiscal policy. As one expert rightly said, "The Government has to use its expenditure and revenue programmes to produce desirable effects and avoid undesirable effects on the national income, production and employment."[5] Though the classical economists did not give much importance to public expenditure, Keynesian economics has given a new trend to fiscal policy and increased the importance of public expenditure as a contra-cyclical method.[6] The subsequent developments in the history of economic thought have further highlighted this aspect.

In recent years, as in any developing country, in Nepal also public expenditure policy has been oriented to the attainment of, first, increase of income to meet the increasing demand of the expanding administrative structure, as provided also by the conception of the welfare state, secondly to meet the growing needs of development activities, and thirdly to redistribute income. The Constitution of the Kingdom of Nepal has the objective of promoting the welfare of the people in the process of economic development. It states: "The aim of the State shall be to promote the welfare of the people by securing and protecting a just social order which brings about harmony in the national life by integrating and consolidating the interests of different classes and professions from a comprehensive national outlook."[7] While the first objective is a subject in itself and is not relevant to the present discussion and the third objective is more connected with the taxation structure, some attempt is made here to deal with the trends of resources for development during the past few years.

[5] H. S. Ellis (Ed.), *A Survey of Contemporary Economics*, Asia, Bombay, 1951, p. 147.

[6] B. Misra, *Fiscal Policy in the Context of Planning*, World Press, Calcutta, 1966, p. 264.

[7] National Planning Council, *The Third Plan*, HMG, Kathmandu, 1965, pp. 11-12.

As explained earlier, resource mobilisation, pruning down and other economic measures have naturally helped in recent years increasingly to provide sizeable resources for development. In the fiscal year 1963/64, for the first time, His Majesty's Government could bear 30 per cent of the total expenditure for development, out of which 21 per cent came from revenue resources and the balance by floating development loans. In the development part of the budget for the fiscal year 1959/60, 76 per cent of the development expenditure was estimated from foreign aid, in 1960/61 about 83 per cent, almost 90 per cent in 1961/62 and 84 per cent in 1962/63, while only 69 per cent was met from foreign assistance in the fiscal year 1963/64. In the fiscal years 1964/65, 1965/66, 1966/67 and 1967/68 this percentage went down still further. This trend, in other words, reflects the Government's efforts to mobilize internal financial resources for development. All such efforts were even more intensified during 1964/65, when 41 per cent of this amount was met by His Majesty's Government and the balance was made available from friendly countries. During 1965/66 to 1969/70, the percentage of the contribution from the Government still went on increasing.

TABLE 2:2

REGULAR PART OF THE BUDGET

(In Millions of Rupees)

	Revenue	*Expenditure*	*Deficit (−) or Surplus (+)*
1956/57	67	66	+1
1957/58	70	84	−14
1958/59	76	80	−4
1959/60	87	86	+1
1960/61	97	110	−13
1961/62	91	104	−13
1962/63	130	124	+6
1963/64	158	114	+44
1964/65	192	118	+74
1965/66	216	147	+69
1966/67	257	170	+87
1967/68 Revised	326.0	181	+145
1968/69 Revised	400.2	202	+198
1969/70 Estimates	442.3	233	+209

Sources: (1) Nepal's Finances, HMG, 1965.
(2) HMG's Budgets.

Table 2:2 shows the cash contribution by the Government to development every year after generating some surplus on the regular part of the budget. It is seen that there has been a gradual increase in the contribution to development finance, in addition to foreign aid. No doubt, such fiscal efforts alone do not enable a country to reduce excessive dependence on foreign aid in the years to come and, for the initial period of economic development, foreign assistance either on a bilateral or a multilateral basis will have to be continued. Still the experience of the other developing countries is replete with examples to show that in due course the foreign trade sector should be expanded at a faster rate.

THE ECONOMIC CLASSIFICATION OF THE BUDGET AND EXPENDITURE

Apart from the above, over the past few years the Government budget has also undergone improvement in the various aspects of its formulation. Economic classification of the budget has been introduced, which has been useful not only for its readers, but it has also helped at the policy formulation level where they enable the decision-makers to review in broad terms the pattern of resource allocation and its impact on the rest of the economy.

The economic classification of the Government budget is an important step even in the construction of a comprehensive system of national accounts for the economy. On the basis of the available statistical information and annual budget estimates, some efforts have been made in the following table to summarize the effects of government transactions in the economy.[8] It groups individual items of expenditure according to their economic characteristics. This is essentially based on the national income accounting technique, and places importance only on investment in gross fixed capital formation, even if at the initial stages some equally important aspects are ignored. That is why, in the budgets after 1962/63, government expenditure has been grouped under three main heads: i.e., general services, social services and economic services. Table 2:3 provides the figures for the past eight years.

[8] Ministry of Finance, *Economic Classification of the Budget,* 1964/65-1965/66, HMG, Kathmandu, July 1966, p. 7.

TABLE 2:3

FUNCTIONAL CLASSIFICATION OF GOVERNMENT EXPENDITURE

(In Thousands of Rupees)

	1962/63	1963/64	1964/65	1965/66	1966/67	1967/68	1968/69	1969/70
A. General Services	7,97,66	7,58,07	7,83,64	8,84,76	11,13,19	13,14,94	14,52,11	15,77,53
B. Social Services	5,00,85	5,39,42	7,92,52	8,10,71	9,32,00	8,78,65	10,41,42	12,55,03
C. Economic Services	14,99,62	15,44,79	16,51,45	24,93,54	30,85,29	28,93,82	39,15,31	52,65,68
D. Others	2,01,86	1,11,99	1,75,23	3,99,44	3,31,62	3,13,77	2,64,91	3,11,35
Total:	29,99,99	29,54,27	34,02,84	45,88,45	54,62,10	54,01,18	66,73,75	84,09,59

Sources : (a) An Economic Classification of the Budget, *Ministry of Finance*, HMG, July 1965, p. 6.
(b) Computed from HMG's Budget.
(c) All the figures, to have comparability, are original estimates.

It is seen from Table 2:3 that expenditure on general services, although almost doubling in absolute terms, during the period, whereas economic services have increased by almost three times. Obviously, this is an encouraging trend. In the early years of economic development, Nepal had to start from a situation where there was not even a workable administrative structure, and naturally concerted efforts were to be diverted towards its improvement and modernization. Under those conditions general and social services were naturally large in early years. With increasing development, expenditure on general services will level off and there will be a gradual increase in economic services. Again, the UN Manual provides for an additional category, i.e., community services; in the above classification, however, community services have been included in social services.

NEED FOR IMPROVEMENTS

In spite of the improvements being gradually initiated in Nepal in more recent years, there is still a long way to go in the budgetary process. More concerted efforts with regard to various improvements in the planning and budgetary techniques and procedures will have to be made. The pruning of regular expenditure and the creation of a surplus for diversion to developmental works are significant features of the recent budgetary policy. The continuation of a budgetary policy for a surplus on current account, with the approach that increases in current expenditure must be less than or be limited to the probable or postulated increases in revenue, will also help to maintain monetary stability.

Of course, improvements made, particularly after 1962, in the processes of both formulation and implementation are producing fruitful results. While presenting the budget for the fiscal year 1962/63, the Finance Minister stated that the proposed functional and economic classification was based on the manual of budget classification recommended by the UN for the whole world. He further added, "I believe that such a budget, classified under financial, political and social heads, will facilitate the study of the financial condition of the country, its programme and an evaluation of the policies."[9] "It is important to recognise that

[9] Ministry of Finance, *The Budget Speech*, Kathmandu, 1962/63, p. 9.

the reforms in the budgetary field will not merely enable a more efficient implementation of development plans; they would also serve to improve and strengthen the techniques of planning themselves by providing more data and more effective measurements of benefits and cost."[10] As a matter of fact, the budget provides for the examination of all the economic aspects of a country's position. That is why, as an expert says, "to fulfill all the purposes the budget account must display two characteristics; it must be simple and it must be comprehensive."[11] Such considerations become obviously more relevant or realistic where adequate statistical data are almost non-existent, or in the process of initial formulation. Of course, neither of these is easy to achieve in a country like Nepal within the framework of the basic limitations even if in principle such aspects have been accepted at the policy level.

[10] United Nations, *Economic Bulletin for Asia and the Far East*, New York, September 1966, p. 15.

[11] Ursula K. Hicks, *Development Finance*, OUP, London 1965, p. 160.

3

TRADITIONAL TAXES

WHILE in the initial stages of a country's economic development, foreign aid gives the initial push, and quite often it is essential for a developing country, in view of the limited resources, it is likely to be effective only when it is made complementary to the finance which a country can raise from domestic resources. In the mobilisation of domestic internal resources, taxes are the most important sources of public revenue.

MAIN ELEMENTS OF TAX POLICY

While devising any taxation policy, it is essential to keep the future expansion of a country in proper perspective. Taxation policy in a developing country should include the following objectives. First, it should help, above other things, in promoting savings in the private sector, which is generally found to be very much undeveloped, and even in the process of elementary evolution. Secondly, it is desired to reduce the very large gap between the incomes of the few rich and many poor. Thirdly, taxation should not have undesirable inhibiting effects in terms of inflationary pressures, and thus it should be counter-inflationary in its action.

Pragmatically speaking, within the framework of the above objectives, taxation in recent times is increasingly being looked upon as a powerful tool in the hands of the government for raising the ratio of savings to national income. It is recognised that, to break out of the vicious circle of poverty, apart from foreign aid, there is need to take resort to vigorous taxation and governmental development programmes. Thus resource mobilisation through taxation has come to be an important function for econo-

mic development in developing countries, and the governments of such countries have to play a central role in the capital formation process. The tax system can be adequately strengthened to yield adequate revenue for the country. The low level of domestic investment should be speeded up as rapidly as possible. Again, most developing countries have the courage to reduce inequalities of income and wealth, and this cannot be effected only by relying particularly on private investment, which might sometimes even increase such inequalities. Of course, it goes without saying that a mixed economy cannot progress without consistently increasing private investment. This makes it clear that, apart from augmenting resources for reducing inequalities in population, such a tax system should be made more progressive with respect to income and wealth.

Obviously, certain pre-conditions will have to be established for the implementation of a successful tax policy to attain the above-mentioned objectives. "The policy must of necessity be based on factual knowledge concerning not only the growing real income of the government expenditure policies, but also a good knowledge of the intersectoral relations of the economy – the key flows of goods and services between agricultural, industrial, commercial, exports and imports."[1]

Experiences have shown that the tax structure of developing countries has evolved haphazardly and almost sporadically and, to a very significant extent, it has been influenced by historical accidents, in some cases by the approaches of the rulers and other occasional exigencies. The level of taxation in each country is conditioned by the standard of living of the people, their household expenditures on essential and non-essential items, and many other similar factors. In any case, a particular tax should always try to embody a compromise between the different and sometimes even conflicting objectives. It should be designed to stimulate the growth of its economy in a manner which is economically and politically feasible, subject to the limitations of administrative capability and a general lack of relevant data and other information.

[1] Ralph K. Davidson, 'Objectives of Tax Policy' in *Fiscal and Monetary Problems in Developing States*, Frederick A. Praeger, New York, 1967, p. 232.

REVENUE SOURCES BEFORE 1951

In Nepal prior to 1951, when there was for all practical purposes no difference between the purse of the ruling Prime Minister and Government funds, the main sources of revenue consisted of traditional items like land revenue, customs and excise duties, royalties on contracts for felling trees and for supplying porters, vehicles and liquor licensing fees and so on, and the system of imposing direct taxation was almost unknown to the country.

Even after 1951, in the process of development, foreign aid became till 1959 the only indispensable source to finance the country's developmental activities, since with government income inadequate even to meet regular expenses, there was no direct saving through surplus even in the regular part of the budget.[2]

The impact of any individual tax on the economy will have to be properly understood in the context of the total tax mixture, which can be seen as an expression of development of the economic society, its aims and structure. For example, in Nepal for many years, the Government had been considering the introduction of some direct taxes in order to mobilise the internal capital of the country, but only the fiscal year 1959/60 saw the beginning of new direct taxes and other modern taxes in the country.

The present chapter seeks to analyse some of the traditional taxes, which will, of course, be followed by an appraisal of more progressive and recent taxes in the following chapter.

LAND REVENUE TAX: SOME PROBLEMS

Of all the taxes the land revenue is the oldest tax and, even today, one of the important sources of revenue. In times gone by, it was probably the only major tax, since customs duties in the modern sense started to be imposed only in the first decade of the present century. However, the later history of the tax in the country, at least till July 1961, has been that neither in its incidence nor

[2] The Nepalese budget has two parts — the regular part and the development part. This has been the custom since 1958. The regular part comprises the recurring administrative expenses, while the development part includes development expenditure tied up with the projects within the periodic plan. Development expenditure in effect represents additional or intensified government efforts in different sectors, and development plans represent such intensified activities.

in the administrative system, did it keep pace with the march of time, and much of its potential usefulness came to be almost lost because of the anachronism which was permitted to crop up with the administration of the tax. Some of the steps taken for improving the administration were *ad hoc* and almost sporadic, without any long-range approach to the basic problems. It was, however, the only financial mainstay in the Rana regime, and it could almost adequately finance the prevailing simple administrative system of the country. As Table 3:1 shows, even after 1951 its contribution to the total revenue, inspite of the fact that a number of new sources of revenue were gradually being tapped, has not, by any means, been less substantial.

TABLE 3:1

TRENDS OF LAND REVENUE

Fiscal Year	*Revenue in Millions of Rs.*	*% Contribution to total Revenue*
1951/52	9.4	30.8
1952/53	13.2	35.0
1953/54	13.1	34.6
1954/55	15.3	29.6
1955/56	21.7	31.9
1956/57	16.0	24.0
1957/58	17.6	25.0
1958/59	18.5	24.1
1959/60	25.6	29.6
1960/61	20.0	20.5
1961/62	28.2	31.0
1962/63	53.0	40.9
1963/64	53.0	33.5
1964/65	43.1	22.4
1965/66	44.5	20.5
1966/67	56.6	22.0
1967/68 Revised estimates	83.3	25.5
1968/69 Revised estimates	86.0	21.4
1969/70 Estimates	86.5	20.2

Sources : (1) *Nepal's Finances,* HMG, 1965.
(2) HMG's Budgets.

It was increasingly found, especially after 1951 when the idea of development found favour with the Government, by fiscal experiences that this source alone was not adequate, either from the administrative angle or from its incidence, and it was not keeping pace with the expanding nature of government expenditure. The existing rate did not have any relation to the level of rising prices over the last almost 4 or 5 decades, the revenue being fixed in cash, without having any proper justification. Again, most of the cultivated lands, which also contributed to the revenue, consisted of tax-free land called *Birta* land, and with the lack of any competent administrative machinery, there used to be significant shortfalls from time to time, even after the system of budgeting started in 1952. During the first few years after 1960, as Table 3:1 shows, the biggest share of total revenue came from land revenue—as much as 41 per cent in the fiscal year 1962/63.

That, even when the rates were raised a number of times after 1960, the percentage of its contribution to the total revenue of the Government has been going down slightly (being 20 per cent in 1969/70) is due, first, in the overall context of the process of mobilising internal resources as emanating from increased trade and commercial activities, to the fact that the yields from some of the new taxes have increased much faster than land revenue itself. Secondly, land revenue as a tax could not have been increased much more in the absence of satisfactory performance in raising agricultural output during the plan period, although over the years, at the development policy level, both technological and institutional measures have received topmost priorities. Obviously, in more recent years, the land reform measures have just started bearing some fruit.

TYPES OF LAND

It will be relevant here to devote some discussion to land tax and its types before the abolition of the *Birta* system in July 1959. Although, strictly speaking, land tax is applied only to the *Raikar* land, it had a close relationship with *Birta* land and *Guthi* land.[3]

[3] Basically, *Raikar, Birta* and *Guthi* have been the main groupings of the land system despite the wide variety of types of tenure prevailing in different parts of the country. In the *Raikar,* there is the *Zamindari* system (now

The land revenue tax is based on a survey of the holding to which the tax applies. While making the survey, two factors are generally taken into consideration. The first is the quality of the land, and for that purpose in different parts of the country different methods prevail. For example, paddy land (very common in the *tarai* region) is divided usually into four categories according to the fertility of the soil, but lands in the hills, i.e. land which does not grow paddy, is not so classified. In order to assess the highlands, a number of measurements used are: *Hale* (plough unit, a plough having two bullocks), *Pate* (a plough unit of one bullock), *Kodale* (a simple unit), and *Bijan* (a seed unit). Thus there is, obviously, ample opportunity for a wide margin of error in making ocular surveys, and the assessments of the units have not been, strictly speaking, except in the cadastral surveys, based on facts but on the opinion of the assessor.

In the *Raikar* land, the rates of tax have not been uniform, varying from one district to another. Although the assessments which form the basis of land revenue tax were always made in kind, most of the tax has in practice always been paid in cash. Historically, the formula for commuting the assessment into cash terms was made at the time of assessment, in most cases some sixty years ago. The rate of commutation varied according to the district, but there were three main types, one in each of the main areas: valley, hills and the *tarai*.

Guthi land does not pay land revenue tax, but pays a rent, based on productivity of the land, to the *Guthi* Commissioners, who administer the endowments. These endowments usually owe their origin to charitable persons who made them in favour of temples or shrines, rest houses, schools or orphanages. The land differs from *Raikar* land in that it pays no tax to the state, but a sort of relationship of landlord and tenant exists between the *Guthi* Commissioner and the person cultivating the holding, the latter paying not tax but a rent to the Commissioners. Formerly, all the income from these endowments used to be paid in kind, while the other half of the 'rent' was commuted to a cash pay-

gradually being abolished) in which the revenue assessment is collected through the *Zamindar*. The *Birta* System has been a peculiar type (abolished in 1959), which implies personal ownership, as distinguished from state ownership. The *Guthi* system refers to such lands which are administered either directly by the state or by monasteries.

ment. In the hills, *Guthi* tenants have been paying mostly in kind. In 1964, the *Guthi* administration was separated from the Government, and an autonomous *Guthi* Corporation was incorporated.

Birta land is broadly described as a grant in perpetuity, made by or on behalf of the Crown, of a right to collect and retain the proceeds arising by way of land revenue tax on a given area of land, in consideration for services rendered to or in return for payments made by the donor to the crown. Before the abolition in July 1959, *Birta* holders in the hills used to be paid in cash, the commutation having been fixed in the same terms as those applying to *Raikar* land; however, it was usual for the smaller holders of *Birta* to receive in kind also. In the *tarai* region, *Birta* land used to be paid at the same rates as *Raikar* land. A special decree, issued in 1955, called for a payment of a graduated tax from 5 per cent to 27½ per cent of the income derived from *Birta* holdings, and in a sense it added to the revenue of the Government.

However, the *Birta* Abolition Act of 1959 had a far-reaching impact, in addition to other economic advantages, in increasing the revenue of the Government. The Act provided for the registration of all *Birta* Land, its acquisition by the Government, and the payment of compensation to the *Birta* holders, on a sliding scale depending on the total income of an individual *Birta* owner, but with a maximum compensation payment of Rs. 12,000. It was easy, apart from certain administrative problems in the beginning, for the Government to instruct the former *Birta* owners' collection offices that their revenues would in future, be handed over to the Government land revenue offices after collection, and not to the *Birta* owners. Of course, expropriation of the *Birta* land in the Kathmandu Valley and the hills has taken quite a long time, and in some of such places remains a problem even now. At the same time, compensation for land taken over in the *tarai* started to be paid, Rs. 3,000 in cash to begin with and the rest by a 3 per cent interest-bearing 10 years' compensation Government bond. One thing, however, is certain: the abolition of the *Birta* from the fiscal year 1959/60 added quite substantially to the revenue of the Government.

RATES OF LAND REVENUE TAX

It will be relevant at this stage to trace the changes effected in

the rates of land revenue in recent years. It was thought at the policy level that, pending the country-wide cadastral survey, increase of land revenue offered the most promising field which could be tapped quickly and easily so as to produce a substantial increase in income. Other things being equal, this could have been done by a simple process of upward revision of the land tax assessment in general. However, till 1961, some of the measures taken were quite haphazard and sporadic with little relevance to prevailing conditions. For example, the Finance Act of 1959 provided for the levy of a surcharge on the land tax. It was levied on the amount of land tax payable to the Government at the prevailing rates. Owing to its complicated nature the existing administrative machinery could not collect the tax, and there were several cases of complete evasion. The Finance Act of 1961 provided for an increase in the rates of land tax in the *tarai* by 25 per cent and in the hills by 28 per cent. The idea was to increase land revenue tax so as to bring it more into line with the real contribution which land had once made to the revenue of the country before the fall in the value of money. The burden of land revenue had not increased though the price of agricultural produce had increased about four to five times from the pre-war level. The Finance Act of 1962 brought about a more significant change. In the *tarai,* where the rates had formerly been up to Rs. 10 per *bigha,*[4] a new uniform rate of Rs. 15 per *bigha* was fixed, and, where the rate had previously been in excess of Rs. 10 per *bigha,* it was raised to Rs. 20. However, in the hill and valley regions, there was to be a flat increase of 40 per cent on the rates of the previous year.These new proposals amounted to an increase of almost 100 per cent in the land revenue. The Finance Act of 1963 brought about certain further refinements with regard to the assessment of land revenue, and for the sake of simplicity also, all payments made in kind were abolished and were turned into cash payments. The primary purpose of these fiscal reforms in the land revenue tax in 1963 was not so much to raise land revenue as to iron out anomalies in the matter of assessment in the hills.

The improvements were carried still further, and the Finance Act of 1966 has been remarkable in the overall context. Stemming

[4] One *bigha* is equal to 1.6 acres.

from traditional and historical factors, in spite of gradual improvements both in the fixing and assessment of land revenue in the country, in various places–the mountainous regions and the *tarai* regions–there had still been different rates without any relation to differences of fertility. As the Finance Minister stated in his budget speech for 1966/67, "a comparison of the land revenue between these three regions – Kathmandu Valley, Hilly region, and *Tarai* regions–would show that the incidence is heaviest in the Kathmandu Valley, and the Hilly region comes next. Such regions naturally include inaccessible areas where cultivation is different, many crops cannot be grown on account of natural conditions, and there are no marketing facilities for the agricultural products. Therefore, it looks justified that the land revenue rates should be higher in the Valley and the *tarai* as compared to the hilly regions."[5] Therefore, the Finance Act of 1966, pending the completion of the cadastral survey, sought to establish a uniform rate all over the country. In some places like the Kathmandu Valley, the rate went down even by 50 per cent, while in the *tarai* region the rate was enhanced considerably. One can criticise that the rate of land revenue should not be fixed arbitrarily, and that there should have been some relationship with the fertility of the land itself. The upward revision, as explained above, and as suggested by one expert, "was levied on the amount of land tax payable to the Government at the prevailing rates, which were conspicuous by bewildering diversities and disparities."[6] But in the absence of completion of the survey data, even some *ad-hoc* arrangements, particularly in the rising trend of agricultural prices, have adequate justification. Hopefully, with lands where the cadastral survey has been completed, the rates will be different, and thus be adequately tied to fertility. Following the devaluation of the Pound Sterling in November 1967, the Nepalese Rupee was also devalued by 24.75 per cent, and to make adjustment in the fiscal position, the land tax was raised further by 50 per cent all over the country.

Although, even now, land revenue constitutes a little more than 20 per cent of the total revenue of the Government, given insti-

[5] Ministry of Finance, *The Budget Speech,* 1966/67, HMG, Kathmandu, pp. 16-17.

[6] B. P. Shrestha, 'Recent Land Tax Measures in Nepal' in *Tribuwan University Journal,* Kathmandu, 1964, p. 6.

tutional and technological improvements, the source of wealth even, in the longer term, lies in agricultural land. The Agricultural Act of 1963 and its amendments pertaining to land reform and land administration, with a development-oriented collection mechanism over the coming years, are steps in this direction. With increased productivity, land revenue tax will play an important role in a land-based country like Nepal. It has been rightly said that 'land taxes are often the only promising means of tapping, in the required large amounts, the income of the agricultural sector, a weighty consideration in view of the key position which agriculture holds in most underdeveloped countries."[7] However, this cannot play its full part in the economic development of the country, unless the agricultural environment is satisfactory. Hence land tax cannot be dealt with in isolation, and it is inextricably connected with general land administration, or to be more correct with the general tax administration. Hence, there is justification for offering some detailed discussion of this tax here. Some of the more important issues connected with the mobilisation of adequate resources from agriculture have been appraised in the concluding chapter.

CUSTOMS DUTIES

Of the traditional taxes, customs provide another important source of Government revenue, which before 1951 was one of the neglected sources of income. While historically land revenue tax is the most important tax in the country, in recent years the receipts from this tax have been overshadowed by the returns from customs and excise. Before 1951 the entire customs administration was left to the responsibility of a handful of contractors who used to levy certain import and export duties on their own, without any relation whatever to the Government fiscal policy. From the Governmental angle, it was just a revenue-earning item, next to land revenue, which, as indicated earlier, was more than adequate to cover the administrative expenses of the Government.

However, things started to change completely after 1951 and, although the Department of Customs was established only in

[7] Haskell P. Wald. *Taxation of Agricultural Land in Underdeveloped Economies,* Cambridge, 1959, p. 3.

1955, tariff policy started to receive some attention, and a number of customs offices, particularly on the southern border adjoining the three states of India, were set up gradually and by 1958 almost all the contracts regarding customs had been abolished. Customs receipts are collected from three main areas, the southern Indian border, the northern border, and the central excise refund which the Government of India has been making to His Majesty's Government on centrally excised commodities. Though the last one is in the nature of excise, this arises by virtue of the customs agreements negotiated with the Government of India in 1954 and modified by a further treaty of 1961. It was mutually agreed to limit administrative measures for collecting duties to a minimum, and prevent any evasion of duty which might take place at the Nepalese-Indian border.

TABLE 3:2

TRENDS OF CUSTOMS REVENUE

Fiscal Year	*Revenue in Millions of Rs.*	*% Contribution to total Revenue*
1951/52	7.3	23.9
1952/53	8.3	22.0
1953/54	10.2	27.0
1954/55	14.2	27.5
1955/56	12.2	17.9
1956/57	24.0	36.0
1957/58	24.3	34.6
1958/59	27.9	36.6
1959/60	32.0	36.9
1960/61	34.4	35.3
1961/62	32.2	35.4
1962/63	37.4	28.8
1963/64	49.3	31.2
1964/65	83.3	43.3
1965/66	93.5	43.1
1966/67	121.7	47.4
1967/68 Revised estimates	129.7	39.7
1968/69 Revised estimates	170.8	42.6
1969/70 Estimates	193.1	43.6

Sources : (1) *Nepal's Finances*, HMG, 1965.

(2) HMG's Budget Speeches.

Table 3:2 makes it clear that there has been an increasing trend of revenue from customs since 1951. Its contribution to the total revenue, which was even a little less than 18 per cent in the fiscal year 1955/56, has gone up to more than 40 per cent in the fiscal year 1969/70. Customs receipts are normally derived from imports and exports of the country. In more recent years, necessary changes have been made for a variety of purposes within the overall economic policy—such as to encourage cottage industries, develop the markets in the *tarai* region, diversify and encourage export trade as far as practicable, and to provide facilities for the increasing demand in the consumer goods.

In this respect, between 1966/67 and 1968/69, after the revaluation of the Nepalese Rupee in June 1966 and its devaluation in December 1967, some fundamental changes in the country's economic development, and fiscal, monetary, industrial, commercial and agricultural policies did quite frequently occur. To obviate any adverse effects of the new monetary policy, the tariff policy of the Government also underwent fundamental changes. However, due to the topographical structure, the open border of more than 500 miles with India, and other administrative difficulties, in spite of certain improvements in customs administration, smuggling and other malpractices could not be completely prevented.

EXCISE DUTIES

The excise duties are levied on commodities which are both consumed and produced internally. Generally, it is always better to levy excise duties on a few selected commodities rather than on many unimportant commodities. This reduces the cost of collection and makes administration more effective. However, in Nepal, it was only since July 1966 that all excise duties on exports were abolished. Otherwise, previously even on exportable commodities, on the conventional basis, excise duties used to be levied. Excises, even levied on a very small number of selected commodities such as matches, jute, sugar, liquor, cigarettes, lumber in saw mills, oilseeds, as Table 3:3 shows, are becoming an important source of income in recent years, particularly after 1964/65.

In recent years, the excise duties, with the increasing speed of the process of development of the country, have been assum-

TABLE 3:3

TRENDS OF EXCISE REVENUE

Fiscal Year	*Revenue in Millions of Rs.*	*% Contribution to total Revenue*
1951/52	0.9	3.0
1952/53	2.0	5.2
1953/54	2.2	5.9
1954/55	3.5	6.8
1955/56	4.8	7.0
1956/57	4.7	7.1
1957/58	5.1	7.2
1958/59	6.5	8.4
1959/60	5.8	8.7
1960/61	6.0	6.2
1961/62	6.9	7.6
1962/63	9.2	7.1
1963/64	10.0	6.3
1964/65	13.8	7.2
1965/66	20.0	9.2
1966/67	20.0	2.7
1967/68 Revised estimates	21.5	6.5
1968/69 Revised estimates	29.8	7.4
1969/70 Estimates	31.2	7.0

Sources : (1) *Nepal's Finances,* HMG, 1965.
(2) HMG's Budgets.

ing some significance, though at a gradual rate. This duty which contributed, as the above table shows, 3 per cent to total revenue in the fiscal year 1951/52, has gone up to about 7 per cent in the fiscal year 1969/70, even though it does not include all the commodities which should be excisable. This is one which is bound to go up gradually in the years to come, in pace with the rate of industrial development of the country.

The experience of the country so far with regard to both customs and excise is indicative of certain broad trends. First, their effectiveness being more dependent on increasing volume of trade and commerce, even of a traditional kind, they are destined to be the most important sources of revenue. With more extensive and improved customs administration being gradually evolved, customs revenue, even without a changing rate, is bound

to rise more consistently in the future. Revenue from both these items can perhaps, other things being equal, be estimated to rise at least at the rate of 15 per cent annually during the coming years.

REVENUE FROM FORESTS

One of the traditional sources of revenue, though not so important from its overall contribution to total revenue, is the forest. Revenue from forests is not part of taxation; it is, in fact, no more than a sale of assets. Though, conventionally, this is being classified under taxes, this source would more properly be classified with the income from trading departments. The forests of the country, which are mostly located in the *tarai* regions and some of the hilly parts at low altitudes, in effect play an important part in the entire economy of the country. From the accompanying Table 3:4 it is noticeable that this has been contributing a little more than 10 per cent to total revenue till the fiscal year 1964/65, but there has been a setback, and its contribution to the total revenue has been less and less significant in recent years. This may be partly due to the fact that there has not been sufficient supervision, and partly also there have been exports in recent years in the form of semi-finished products. In the past, the scientific approach to silviculture has been neglected and the sales of stumpage to contractors has resulted in the felling of trees without any efforts being made to replant areas where felling has been done. This will also account for the increase of domestic demand on the forest resources inside the country. Though even good forest management may not add considerably to the revenue, it is very important that forests should be rehabilitated for the future. More serious efforts on a concerted basis will be necessary in the coming years.

From the analysis of the types of taxes made so far in this chapter, it is evident that, in spite of the introduction of a number of new taxation measures in recent years, the taxes of a traditional nature will have to play a significant role in the finances of the country. From the standpoint of the total governmental revenue, this trend will be bound to continue for many years to come. It is therefore imperative that timely improvements are effected in the tax-collecting machinery. At the same time, there

should emerge greater political courage to improve the tax structure. Obviously, such steps will gradually provide much scope even for the mobilisation of additional resources.

TABLE 3:4

TRENDS OF REVENUE FROM FORESTS

Fiscal Year	*Revenue in Millions of Rs.*	*% Contribution to total Revenue*
1951/52	3.0	9.8
1952/53	2.4	6.3
1953/54	2.9	7.7
1954/55	6.1	11.8
1955/56	8.2	12.1
1956/57	7.5	11.2
1957/58	7.7	10.9
1958/59	8.1	10.6
1959/60	12.0	13.9
1960/61	12.0	12.3
1961/62	8.7	9.5
1962/63	9.8	7.6
1963/64	13.4	8.5
1964/65	20.9	10.3
1965/66	19.4	8.1
1966/67	16.5	6.4
1967/68 Revised estimates	21.8	6.6
1968/69 Revised estimates	20.1	5.0
1969/70 Estimates	20.4	4.6

Sources : (1) *Nepal's Finances,* HMG, 1965.
(2) HMG's Budgets.

4

TAXATION POLICY

For a country like Nepal, which is making consistent efforts to pass from a stage of comparative backwardness in economic development to one of self-sustaining growth and economic maturity, it is imperative that resources are increasingly mobilised at the optimum level. As regards the use of increments in national income for the attainment of social justice, the experience of other developing countries shows that traditional sources of revenue alone are not adequate. Gradually but increasingly, new sources—both in taxation and other fields—will have to be tapped, corresponding with the rate of economic development which the country has set as the goal. As in any other developing country the incidence of taxation on rural income in Nepal has so far been quite low since the rigidity in the rural conditions, with lack of substantial productivity, has not enabled the Government to tap adequate resources from agriculture. Furthermore, the incidence has also been quite low even in the urban sector. Therefore, in full consideration of the taxation tolerance, new resources will gradually have to be tapped. This chapter therefore seeks to analyse more recent trends in the field of new taxes. It should however be borne in mind that, in spite of many advantages of the direct taxes, under the peculiar conditions of the Nepalese economy increasing reliance needs to be placed for many years to come on indirect taxes to increase the savings of the economy, and thus support economic development.

FISCAL CONTRIBUTION TO DEVELOPMENT

In Nepal before 1951, the overall fiscal system, as explained in

the preceding chapter, was rudimentary and not geared to any positive consideration with definite objectives. Even after 1952, when a national budget was prepared with elementary statistics and legislated, the early experiences were characterised by *ad hoc* decisions and inconsistent activities. This was of course almost natural, at a time when government policy was not oriented to restricting expenditure in the regular part of the budget to a minimum consistent with administrative efficiency.

The budgetary figures show that the overall deficits, during the decade between the fiscal year 1951/52 and the fiscal year 1960/61, had a total of Rs. 196.0 million. Almost every year, the budget ran further into deficit except in the fiscal years 1956/57 and 1959/60. It was only after the fiscal year 1961/62, as will be explained in the following lines, that conditions started gradually improving; there has been a specific departure from the tendency of merely emphasising the traditional types of taxes and other similar sources of revenue.

In fact, within a period of one decade, the regular or revenue part of the expenditure increased from Rs. 42 million to Rs. 110 million, i.e., by almost 162 per cent. Such a sharp increase in Government expenditure naturally placed an excessive burden on the exchequer. In essence, very little extra increase could be generated each year from traditional sources of revenue. As the people's rising expectations kept demanding more modern and higher standards of living, new Ministries and departments were set up to meet the administrative requirements as quickly as possible, 'while at the same time the old departments also considerably increased in size to provide for the expanding tasks of administration.'[1]

NEW SOURCES OF REVENUE: CONDITIONS BEFORE 1960

Till 1960, no consistent efforts were made to increase the revenue proportionately, either by increasing traditional rates or by introducing some new and modern sources of revenue. The inelasticity of revenue system led to a number of other problems. Of course, there were problems in the overall context of Nepal's conditions. It has been rightly said, "Many such governments,

[1] Ministry of Finance, *Nepal's Finances,* HMG, Kathmandu, 1965, p. 13.

for example, in the quest for more and more revenues, have adopted *ad hoc* tax measures that have piled tax upon tax and made the revenue systems exceedingly complex. Such *ad hoc* measures pay little attention to the consequent discouragement of production and investment."[2] In Nepal also, in spite of the fact that some measures were taken during the period for increasing revenue, the results were not encouraging on the average. For example, between the fiscal years 1951/52 and 1960/61, the revenue increased only from Rs. 30.5 million to Rs. 97.4 million, i.e. a 22 per cent increase per annum. During the same period expenditure went up from Rs. 42 million to Rs. 110.1 million, i.e. almost by 16 per cent per annum.

In other words, trends in the fields of revenue and expenditure adequately show that the country, during the period before 1960, was living beyond its means. The total deficits in the revenue or regular part of the budget were about Rs. 97 million. All such deficits were met largely by drawing on reserves from the main government treasury (*Bhandarkhal*), where a surplus had accumulated over the previous years. However, after 1957, there were no further deposits. Obviously, the overall emphasis was placed on maintaining traditional aspects in the budget, rather than systematically bringing about progressive changes, emanating from cumulative experience, to suit the national economy. The overall result was that the Government was encountering financial difficulties year by year, though this was not realised on a comprehensive basis by the Government during this period.

As explained in Chapter 3, the main sources of revenue were the traditional land taxes, and there was no tradition of imposing direct taxes like income tax. Taxes like urban property tax, business profits tax and revenue surcharges were introduced only with effect from the fiscal year 1959/60. However, they could not be collected properly according to the original estimates, and the actual performance was poor. The main reasons were the lack of tax-paying habits of the people, as well as the underdeveloped and unscientific nature of the taxation assessment procedure, and the entire system of tax administration.

Since the government revenue was not adequate even to meet regular expenses, during the period of the First Five Year Plan

[2] IMF and IBRD, *Finance and Development,* Washington, December 1965, pp. 231-32.

(September 1956-61) the country had to depend quite heavily on foreign aid for development.

The total developmental expenditure, amounting to Rs. 220 million during the plan period, was almost all met by foreign grants. As the Plan document rightly clarifies, "a realistic appraisal of the Five Year Plan reveals that it aimed at providing Rs. 95 million from internal resources. But the actual expenditure shows that the amount borne by His Majesty's Government did not exceed Rs. 60 million—a short fall of a little above 30 per cent."[3]

NEW TAXES: AFTER 1960

After 1960 in the country, as against the preceding years, some fundamental changes took place in the fiscal field, particularly in increasing the Government revenue by exploiting the new sources for taxation. Resources were allocated through fiscal measures, against the early experiences when government policy was not geared to restraining expenditure in the regular part of the budget to a minimum consistent with administrative efficiency. A revenue surplus of Rs. 44 million could be effected during the fiscal year 1963/64 and Rs. 74 million for the fiscal year 1964/65. For the fiscal year 1968/69 the original estimates have been put at Rs. 156 million. Obviously, this has increased the percentage of His Majesty's Government's cash contribution to the development part of the budget, and thereby a favourable condition is being created for stepping up investment in the country. In addition to new tax measures, more effective tax collection—both direct and indirect—has been brought about. For instance, between the fiscal years 1951/52 and 1960/61, revenue increased from Rs. 30.5 million to Rs. 97 million, i.e. a 22 per cent average annual increase, while between the fiscal years 1961/62 and 1968/69 it has gone up by almost four times. The original revenue estimates from the existing sources for the fiscal year 1968/69 will be higher by Rs. 58 million, or by 19 per cent, than the revised estimates for the fiscal year 1967/68.

[3] National Planning Council, *The Three Year Plan*, HMG, Kathmandu, 1963, p. 28.

INCOME TAX

It was only in 1960 that the Department of Tax was set up to deal with a number of new taxes such as income tax and a number of other taxes.[4] Tax on income and property accounts for a substantial portion of total revenue in industrially developed countries. In Nepal, however, it is a very new tax and its contribution is still very low, contributing only about four per cent to the total government revenue. While tax on income has increasingly accounted for a substantial portion of total revenue in most other countries. Of course, the portion of the imposition of income tax, which started during the fiscal year 1962/63, has been tended in principle, first, to reduce the unequal distribution of wealth with social justice, and also to create the tax-paying habit in the people rather than just to add to Government revenue. It has had a commendable beginning because, prior to this, there were different kinds of taxes like those on profits and remuneration, tax on rented houses, etc., but there was neither uniformity nor simplicity in the tax administration, in keeping with any semblance of proper organisation, and the method was complex and unscientific. As a result, tax could not be collected properly according to the original estimates. In order to wipe out these deficiencies, and on the basis of both equity and simplicity, comprehensive income tax was introduced in the fiscal year 1962/63 and since then, both the method and procedure, though still retaining some of its underdeveloped and traditional nature, have become more scientific and better organised with the progress of time.

The Income Tax Law for the fiscal year 1962/63 exempted annual incomes of up to Rs. 7000, but during the fiscal year 1963/64 the exemption level was reduced to Rs. 6000. To-day the minimum rate is 7 per cent and the maximum rate is 55 per cent. The basic principle of income tax should be progressive incidence in the rates of payment with simplicity and efficiency of administration and collection. In Nepal, however, since this tax is still in its infancy, the rates have not been so steep in progression as they are ordinarily found to be in other developing countries.

[4] These new taxes so far levied include the following: radio licence, urban property tax, income tax, foreign investments, sales tax, business profits tax, entertainment tax, hotel tax, embarkation tax and revenue stamps.

Obviously, this aspect should always be related to the tax-paying habits and taxable capacity or tax potential of the people in the initial stages of economic development. At any moment, the possibility of raising additional taxation will be determined by several social, economic and political factors. Of course, progression is a controversial issue. For example, a study of Indian tax structure shows the following: "When an Indian tax payer enjoys an income 50 times as high as the national income per capita income, he pays only 7.3 per cent of his income in income tax, while an Australian tax-payer at that relative income layer pays 57 per cent and a British tax-payer 65 per cent of his income. In 1950 a Japanese citizen had to pay 20 per cent in income tax on the first slab of his earned income above the minimum exemption limit, when he attained hardly double the national per capita income. In India, under the 1958/59 schedule, one pays 20 per cent of one's income only when one grows 60 times richer than the average citizen."[5]

In Nepal, although some improvements are being made in the rate structure, a number of issues towards scientific basis still remain to be resolved, because of various difficulties in the early stages. For the fiscal year 1967/68 in keeping with practical considerations, the following changes in the rates of personal income tax were effected, and these exemption rates were maintained for the fiscal year 1968/69 also:

(a) Tax exemption limit for unmarried individual up to Rs. 3000;
(b) Tax exemption limit for married individual up to Rs. 4500;
(c) Tax exemption limit for the married with dependents up to Rs. 6000.

In developing countries, tax on incomes has been classified under various heads; but in Nepal no sophisticated approach has been adopted so far. This simplicity is called for in the country's existing conditions.

In fact, taxation is a matter of habit and in Nepal, in both of the tax administration and the attitude of the paying public, it cannot be raised all at once without buying some time over the

[5] G. S. Sahota, *Indian Tax Structure and Economic Development*, Asia, Bombay, 1961, pp. 35-36.

next few years. However, the revenue from this tax has been increasing quite fast—about seven times within eight years. This is obviously an encouraging trend from a longer angle. Over future years, an increase of more than 25 per cent is expected each year, with a further improvement in tax administration on the part of the Government, and in economic and social attitudes on the part of the tax-paying people. This is well evidenced, as the following table shows, by the increase in recent years.[6]

TABLE 4:1

TRENDS OF REVENUE FROM INCOME TAX

Fiscal Year	*Revenue in Millions of Rs.*	*% contribution to total Revenue*
1962/63	2.0	1.5
1963/64	2.7	1.7
1964/65	5.3	2.7
1965/66	7.1	3.3
1966/67	8.1	3.0
1967/68 Revised estimates	11.4	3.5
1968/69 Revised estimates	14.7	3.6
1969/70 Estimates	16.2	3.6

Sources: (1) *Nepal's Finances*, HMG, 1965.
(2) HMG's Budget Speeches.

PROPERTY TAX

Property tax is yet another variant of income tax. Though property tax was started in the fiscal year 1959/60, it could not be collected effectively due to many complexities in the method of tax administration and in the socio-structures of the tax-paying public. In the following years, however, some practical changes were introduced to make the tax structure more simple and efficient. Property tax includes taxes on urban housing property and on foreign investment. The valuation of urban houses is done according to these broad major factors:

[6] From the fiscal year 1966/67 all the corporate organizations (sole proprietorship or partnership firms), which are either registered or unregistered under the Nepal Company Act, were taxed at the rate of 6 per cent up to Rs. 10,000 net profit, and profits above Rs. 10,000 were taxed on the same basis as the personal income.

average cost of the building in conjunction with zonal importance, road importance, construction year of the building and the rate of depreciation, and the value of the land within the building compound. Even then, the method of assessment so far used may be described as crude, but this is perhaps a classic example of imposing taxation in a manner which can be understood by the public and applied by the administration. There is a difficulty with regard to enforcement, since under the present system householders are expected to come to the tax office and ask for the appropriate forms which they then complete and return to the office where the assessment is made. The revenue from property tax, of course, does not seem to have very good prospects in the future with the gradual break-up of the joint family system and changes in the structure of society. The yield from the urban house and land tax has increased from Rs. 0.5 million in the fiscal year 1962/63 to Rs. 1.7 million in the fiscal year 1968/69. However, property tax will contribute a great deal towards reducing the unequal distribution of wealth and ensuring social justice, as adequate adjustments both in assessment and collection are made from time to time.

Thus, in general, it can be seen that, even if it has been very modestly started, the yield from direct taxes has shown an upward trend within a few years of its inception. Direct taxation has raised revenue over the course of time for the Government and contributed gradually to equalising the distribution of wealth. In fact, taxation is a matter of coordination between the tax administration and the tax-payer. Recent developments like the increasing trend in both tax collection and public interest in national development activities, and greater confidence in the government, indicate healthy signs and encouraging prospects for the future.

TAX ADMINISTRATION AND INDIRECT TAXATION

Direct taxes such as income tax are delicate and technically complex by their nature. With the difficulty in designing and administering a system of income taxation, it is widely argued that indirect taxation should play a major role in the tax structure of developing economies, and in most of the developing states indirect taxation does account for the bulk of tax revenues, largely

because it is administratively much simpler to collect.[7] The experience of a number of developing countries has shown that, even though improvements can be made to increase revenue from income taxes, business and property taxes and agricultural taxes, greater reliance will still have to be placed on indirect taxes. In the initial stages of development the role of indirect taxes cannot and should not be minimised; of course it is necessary that, even within the indirect taxes, a broad element of progression should be introduced. On the whole, the tax base should be widened, the rates of old taxes should be appropriately increased and, at the same time, flexibility should be built into the tax structure so that tax yields are automatically increased along with the increase in national income.

In Nepal also, the Government seems to have realised in recent years that the success of tax collection lies mostly in its administrative capabilities and trained personnel. Training of officers both inside and outside, will have to be continued for a long time to come, in order to enhance the administrative capabilities of those persons who have brought more efficiency and dedication to their duties. However, the structure of indirect taxation has to be fashioned with almost the same objectives as direct taxation. That this approach has been adopted in recent years in Nepal is evidenced by the sales tax which was introduced in 1965 at the rate of 2 per cent of the sale price on some selected commodities—not including food and drinks, medicines, coarse cloth, and reading and writing materials among other items. This selective approach was further improved in 1966, based on practical experience, when taxable goods were classified into three groups on the basis of the character of the commodities, and the taxes were levied at the rates of 3 per cent and 4 per cent of the sales prices respectively. In consideration of the administrative difficulties, and to check the leakage, the sales tax on the items of the third group were to be collected at source. This is, as a matter of experience, one simple way of introducing progression in indirect taxes. There are high rates on luxuries and low rates on articles of common consumption, and basic necessities are completely exempted. It can be said that this has helped to

[7] Ralph K. Davidson, 'Objectives of Tax Policy', in *Fiscal and Monetary Problems in Developing States*, Frederick A. Praeger, New York, 1967, p. 235.

restrain the consumption on non-essentials or luxuries, and it has enabled some resources also to be mobilised. The yield from this tax in 1965/66 was Rs. 6.3 million; it rose to Rs. 43.3 million in 1968/69—more than a sevenfold increase.

However, in comparison to other countries, the tax burden in Nepal is still quite small. In Ceylon, 22 per cent of the national income is taken by way of taxation and other imposts, in Burma the figure is 19 per cent, in India 10 per cent, in Pakistan 12 per cent, and it is between 20 and 30 per cent in developed countries. In Nepal, the amount of national income which is paid in taxation and other imposts does not exceed 3 per cent, and it will reach some 4 per cent of gross domestic product by 1969/70.[8] However, with increasing mobilisation of resources, this figure might not be less than 6 per cent. Even this is deplorably low compared to other developing countries.

Direct taxes have not been able to contribute sufficiently in increasing government income and in reducing the unequal distribution of income among the people. The underdeveloped economy of the country, the people's lack of tax-paying habits, the low incomes of the majority of the population and the poor efficiency of the administrative machinery to collect progressive taxes, have all been responsible factors. However, improvements are under way in all these fields, and direct tax is undoubtedly destined to become one of the major sources of Government revenue, looked at, of course, in a longer-range perspective.

Progressive taxation in the form of taxes on income and wealth is of importance as a deliberate corrective to spontaneous economic forces which produce steadily growing inequality. Many of our problems can be solved by increasing taxes, but the pressing need for large government outlays for economic development strongly influences the approach to the problem of determining the appropriate level of taxation in a developing country. In a highly developed economy, tax policy tends to accept that the level of expenditures depends much more heavily on the ability of the tax system to place the required resources at the disposal of the government. By the same token, the size of the government's development programme depends in large part on the economic and administrative capacity of its tax system to marshal the neces-

[8] National Planning Council, *The Third Plan*, HMG, Kathmandu, 1965, p. 36.

sary resources from time to time. In this sense, the sequence of decision tends to run from taxation to expenditures.

NEED FOR INCREASE IN TAXATION

Recognizing the strategic importance of an adequate flow of tax revenues—and the inadequacy of their own revenues—the governments of many developing countries have sought to increase the proportion of national income collected in taxes. Much of the increased demand for technical assistance in fiscal matters since the Second World War apparently grew out of this desire for a more productive tax system. Underdeveloped countries are under no illusion that they can—or should—push their tax ratios of 10 to 15 per cent of national income, or even less, to the 20 to 30 percent levels reached in such advanced countries as Austria, Belgium, France, Germany, the Netherlands, Norway, the United Kingdom, and the United States. But they are aware that even a modest increase in taxation may be able to finance large percentage increase in the government's contribution to the development programmes. This approach has been reflected in principle in the current policy decisions of His Majesty's Government. Experience shows, first, that the less advanced is the economy of a country, generally, the lower is the ratio of tax payments to national income. It shows, secondly, that through intensive administrative and legislative efforts, several developing countries have considerably increased their ratios in post-war years. For example, the Philippines increased its tax revenue by 80 per cent from 1950 to 1961.

The point up to which taxation can be raised with positive gains, and where the optimum level lies, permits of no doctrinaire answer. It will differ from country to country depending on the preference of citizens or even the taxation tolerance of the country, the administrative competence in government, the relative importance of existing tax levels, on the one hand, and undeveloped economies, on the other, as barriers to private investment, and many other factors. As regards taxation, one of the key factors in any country is whether additional taxes can be so levied as to tap funds that otherwise would have gone into such channels as luxury consumption, socially unproductive investment or foreign exchange hoarding, or whether they would

simply displace private productive investment and essential consumption. Ultimately it is only through careful enquiry into economic characteristics, social and cultural institutions and prevailing standards of tax administration and compliance that an intelligent approximation can be provided for any given country.

However, even with such strong adherence to direct taxes, as an inevitable accompaniment to under-development in Nepal, the ratio of direct taxes to the total tax revenue has been small. As Prof. Lewis would say, "The biggest yielders of revenue in underdeveloped countries are the taxes on commodities—import, export and excise duties. They are easiest to collect, administratively, when commodities pass through the hands of a few wholesalers in a small number of places."[9] Nepal has been able during the past few years to give added confidence in general, by its increased emphasis on direct taxes, even if their percentage yield has not been substantial, as in any other developing country, and there has still been dependence predominantly on commodity taxes. The country has shown, by comparison with others, that given the right atmosphere and serious efforts, government savings for development planning can be generated almost from nothing to more than 40 per cent of the current expenditure with reasonable stability.[10] There is reason to believe that well-devised policy measures can succeed in making available a larger flow of resources for economic development. Still in general, Nepal's fiscal policy in recent years has been to finance large and growing government expenditure in an orderly and efficient manner, and greater reliance is being placed on saving for development through current Government budgets.

In spite of certain limitations and difficulties in the beginning years, today taxation is accepted as a major method of promoting economic growth and of achieving social goals.[11] Professor Kaldor has stressed that the danger is that political power is the key to the distribution of wealth. However, at the same time,

[9] W. Arthur Lewis, *Development Planning*, Harper & Row, New York, 1966, p. 121.

[10] In view of price rise and monetary expansion this is, of course, a controversial issue, which has been discussed more thoroughly in one of the following chapters.

[11] Nicholas Kaldor, 'Taxation in Developing States', in *Fiscal and Monetary Problems in Developing States*, Frederick A. Praeger, New York, 1967, p. 209.

'the masses should be introduced to it gradually, as part of the pattern of social, political and economic reforms.'[12] For this it would be necessary for any government to assess and collect revenue and the overall confidence of the tax-paying citizens should be generated. Generally, the tax payer's resistance to suffering cuts in his income is conditioned by various factors such as low per capita income, lack of development consciousness, and psychological and political effects inherited from olden days. These conditioning factors, as the above study shows, His Majesty's Government has been trying gradually to alter.

Another condition is regarded to be the intelligence and incorruptability of the tax-assessing and -collecting officers. Obviously, inefficiency and low integrity in the tax administrative staff, coupled with a lack of tax morality among the tax payers, lead to much avoidance and evasion. That is why Prof. Kaldor suggests, above other things, that any additional outlay devoted to improving the status and pay of the officials of the revenue department is likely to yield a high return in terms of increased revenue.[13] That this aspect is being recognised in principle at the policy level by His Majesty's Government can be seen from the recent policy announcements. For example, while presenting the budget for the fiscal year 1968/69 to the Rastriya Panchayat the Finance Minister stressed: "On the taxation side, it is felt that, instead of increasing the tax rates, the tax administration should be simplified and made more comprehensive."[14] However, the attainment of these objectives is fraught with a number of practical problems, and even if efforts are consistently made it will take quite a number of years to resolve all issues connected with them.

[12] See my comments on *Professor Kaldor's New Taxes* in the Rehovoth Conference on Fiscal and Monetary Problems in Developing States, Jerusalem, April 9-18, 1965, p. 8.

[13] *Ibid.*, p. 219.

[14] Ministry of Finance, *The Budget Speech*, 1968/69, Kathmandu, p. 12.

5

AID AND LOAN

TODAY the world-wide shortage of capital is becoming an increasingly decisive and influential factor in the economic structure of the world. This shortage, in addition to other factors of economic growth, is more significant in the underdeveloped parts of the world, which, in view of the substantial rate of economic development to be achieved, will have to be supported by foreign aid at least in the initial stages of development. However, the rapid formation of capital for the accelerated growth of such countries is not possible without foreign assistance. Experience so far, in the global context, has not been very encouraging. For example, "the net official flow of long-term capital from the rich members of the World Bank to the poor members is now about $6 thousand million a year, or less than six-tenths of one percent of the combined gross national product of the rich countries."[1] One reason for this meagre accomplishment in the UN Development decade, which has almost turned into a decade of disappointment, is the slow performance of many economies in the underdeveloped parts of the world. The growth rate of developing countries, as a whole, slowed down from an annual average of 4½ per cent in 1955-60 to 4 per cent in 1960-63. Thus the goal of attaining the 5 per cent annual rate of growth, set by the United Nations General Assembly in 1960 for this decade, other things being equal, does not seem within the reach of developing countries.

However, it goes without saying that the need for foreign aid,

[1] Escott Reid, 'The Crisis in Foreign Aid', in *The World Today,* London, August 1966, p. 5.

besides a number of difficulties typical of a developing economy, arises from a relative inadequacy of domestic savings. Experience in Asia in recent years shows that, in a number of countries in various stages of planning, aid from outside has played a helpful role in financing economic developmental programmes. In the overall context of the extreme poverty of the people, budgetary difficulties and lack of trained manpower for properly implementing development programmes, even with the maximum mobilisation of existing internal resources, foreign aid helps in pushing up the rate of economic growth in the initial stages of growth. Of course, in recent years long-term loans are being increasingly stressed both on a bilateral and a multilateral basis. For example, during 1961 in the global context, more than 30 per cent of the bilateral, long-term loans to developing countries by the developed countries had a maturity period of twenty years or more.

In Nepal, it was only after its long insulation ended in 1951 that the country could get foreign aid or economic cooperation from outside for the economic development of the country. True, without establishing proper international cooperation and dedication to positive action, no country can generate economic relations on a coordinated basis. Although after 1951 the country started to have international collaboration in its development schemes from countries like India, the USA, the People's Republic of China, the USSR, the United Kingdom, Switzerland and others, it was only after the launching of the First Five Year Plan in 1956 that a more substantial and co-ordinated approach could gradually evolve in the field of economic cooperation.

FOREIGN AID IN GRANTS

Though this is not the place for giving a detailed account of economic assistance from a number of countries and international bodies, it is pertinent to make certain broad remarks with regard to the utilization of free grants in aid in Nepal.

That, after 1951/52, assistance for economic development from a number of countries has been quite substantial is evidenced from Table 5:1 though after 1964/65 in absolute figures the amount of grants from various countries has been more or less stabilised. This trend has been also due to the fact that His Majesty's Government could increasingly generate an annual

TABLE 5 : 1

FOREIGN AID TO NEPAL

1951/52 = 1968/69 *(In Thousands of Rupees)*

Country	*America*	*India*	*China*	*Russia*	*Others*	*Total*
1951/52 to 1955/56*	2,49,51	7,00,18	—	—	—	9,49,69
1956/57	1,27,23	1,45,70	—	—	—	2,72,93
1957/58	4,84,73	96,05	—	—	—	5,80,78
1958/59	1,79,51	1,71,02	—	—	—	3,50,53
1959/60	5,62,25	1,84,50	3,21,35	—	1,85,30	12,53,40
1960/61	8,69,97	2,23,55	--	84,56	1,92,91	13,70,99
1961/62	Not available					69,568†
1962/63	4,68,00	1,36,00	32,00	1,50,00	51,00	8,37,00
1963/64	7,44,00	3,40,00	1,47,00	3,34,00	94,00	16,59,00
1964/65‡	7,63,00	6,24,00	2,71,00	86,00	84,00	18,28,00
1965/66	5,79,00	9,30,00	1,62,00	50,00	32,00	17,53,00
1966/67	3,49,26	7,76,33	2,45,83	48,75	2,19	14,22,36
1967/68	3,22,26	9,58,67	2,61,65	30,69	5,37	15,81,14
1968/69	8,69,49	12,61,85	4,68,79	38,00	4,32	21,42,45
1969/70	6,66,47	16,63,01	7,66,70	45,00	1,51,56	32,92,79
Total	63,85,42	74,43,53	24,30,49	8,18,25	8,00,46	1,78,78,15

* Yearwise breakdowns are not available.

† Data for non-Budgetary expenditure for the year 1961/62 are not available.

‡ Actuals of the foreign aid included in the Budget as published in the Budget Speech 1966/67 — America Rs. 65.5 million, India 6.25 million, China 12.1 million, Russia 4.0 million and others .2 million

Sources : (1) Department of Research and Statistics, Nepal Rastra Bank.
(2) Ministry of Finance, HMG.

surplus from the revenue or regular part of the budget for development activities after 1964/65.

It is also obvious that, of all the countries, India has been occupying the topmost position in providing economic assistance to Nepal. True, the country has been associated more intimately with India because the two are contiguous, face almost common problems and have common ties of culture and tradition. Over the years, Indian assistance has gone mainly to three types of activities—improvement of transport and communication, rural development through schemes of village and local development, irrigation works and power development. In addition, the country has also provided assistance in fields of technical and social services. The first project to be started was the construction of the Tribhuvan International Airport, although in March 1956 an Indian Aid Mission, now called the Indian Cooperation Mission in Kathmandu, was started to deal with the aid programme in a co-ordinated manner, in close co-operation with the officials of His Majesty's Government. Indian aid has been instrumental in the development of horticultural stations in different agro-climatic zones of the country. Assistance has also been provided in setting up a network of hospital-cum-cattle breeding centres all over the country for the treatment and improvement of livestock. Both in major and minor irrigation projects also the assistance has been available.

Economic assistance by the United States started in 1952, when the United States Operation Mission was set up. The Nepalese-American Technical Cooperation Programme was signed on January 23, 1951. In the words of the first director of the Mission: "There have been quite a number of co-operative programmes and project agreements signed since then, covering the fields of village development, agriculture, irrigation, education, public health and nursing."[2] Looking at United States aid to Nepal, three types of activity have been important. First, for integrating the various parts of the country physically, transportation and communication projects are being implemented. Secondly, assistance is available in solving the problem of expanding Government services like health, education, technical training and administration in all

[2] W. Rose, *Nepal — A Little Country with Big Problems*, Kathmandu, 1954, p. 9.

parts of the country as much as possible. Thirdly substantial help has been given to increasing national production in other various ways. While American aid at the beginning was limited in volume, and both financial and technical aid was utilized in agriculture, irrigation and village development projects; with the increase of US aid over the subsequent years, the scope of utilization has also been progressively expanded.[3]

The Soviet Union has been assisting quite considerably in recent years, particularly after 1962 in the fields of industry and transport. Three factories—one for sugar and one for cigarettes—have been constructed and one agricultural implements factory, besides which a hydro-electric plant in Kathmandu and one sector of the East-West Highway (now under construction) have been the main projects. In the field of the country's overall process of industrialisation, the assistance offered by the People's Republic of China substantially increased after 1961 and the fields covered are road construction, a leather and shoe factory and a number of warehouses. During the current plan period, the Kathmandu-Kodari road and a brick and tile factory have been completed.

Assistance from the United Kingdom has been in the fields of power plants, i.e. diesel generators, equipment for the Kathmandu Valley distribution scheme, and the Dharan electrification scheme. Also included have been educational activities and, at present, the construction of a model school and one sector of the East-West Highway. Switzerland has been providing assistance through SATA in the development of dairy production, and other activities in the field of small-scale and cottage industries. Assistance from the Australian Government has been made available in equipment for road construction, radio and broadcasting equipment for Radio Nepal, and X-ray equipment for the chest clinic. The activities of the Japanese Government have included taking one hydro-electric survey, surveys for the iron and steel industry, and a paper factory. Economic aid from New Zealand has been concentrated in the field of agriculture. It has been directed to a pasture improvement and sheep husbandry project in Pokhara and to the Kathmandu Central Dairy.

[3] See my book, *Nepal's Economic Development on International Basis*, Kathmandu, 1962, p. 45

The United Nations and its specialized bodies, other international organizations such as the International Bank for Reconstruction and Development, the International Development Association and the Asian Development Bank have been providing technical advisory services and both feasibility and pre-investment surveys in different fields. In general, the past and present programmes of the various aid-giving countries have had a strong impact on the national economy.

Thus while the assistance so far received by Nepal from different countries has been available in four main forms—cash contribution, commodity contribution, training facilities and technical services—each individual country has more or less specialised in particular kinds of development project, of course, in certain cases as desired by the contributing countries. Substantial technical assistance has been provided by India, Canada, New Zealand, Britain and Australia under the Colombo Plan. In addition, various International Organizations have been helping in different ways in the economic development of the country. While in the beginning there used to be difficulties in utilizing foreign aid, in recent years these problems are being gradually resolved both in administration and at the policy formation levels. Now the problem is more of evaluating the physical results and less of increasing the absorbitive capacity in the implementation of the individual projects implemented either by His Majesty's Government itself or in collaboration with the aid-giving countries.

FOREIGN LOANS

The grants-in-aid in developing countries have been increasingly replaced in recent years by loans, which are also foreign aid. As one expert rightly suggests: "The mounting external debt burdens of the developing countries emphasise the need of soft-term loans. Furthermore, if development loans are made in soft terms rather than hard, the job of development will be finished sooner, and the United States and other donors will have to furnish less total aid."[4] Still in the global context, debt servicing is a problem in developing countries inextricably connected with the rate of

[4] David Horowitz, *Economic Disparity among Nations*, Baltimore, 1966, p. 62.

economic development. Debt service payments are a charge on domestic real income and savings, and such payments have accordingly to be transferred abroad either by expanding exports, by curtailing imports or by further borrowing from abroad. In Nepal this aspect has not reached any serious dimensions in view of increasing emphasis on and availability of aid as outright grants so far; however, it will assume great significance in future years. It was after 1960 that, in order to step up the rate of economic growth more rapidly—resource mobilisation by taxes, other internal sources and foreign grants combined being inadequate—that advantage has been taken of external and internal loans as supplements. Therefore, only after the commencement of the

TABLE 5 : 2

EXTERNAL LOANS

(In Millions of Rupees)

1. *External Loan*	*Amount*	*Rate of Interest*
A. Russian Loan	Roubles 2.5	2.5%
B. U.K. Loan*	£ 0.8	7.125%
C. Indian Loan	IC 10.0	3%
D. U.S. Aid†		
(i) No. 367-003	$ 1.0	4.25%
(ii) No. 367-004	$ 1.0	4.25%
(iii) No. 367-006	$ 2.0	5.0%
E. U.S. EX-IM Bank‡	$ 1.0	4.0%
2. External Loans to NIDC Guaranteed by HMG		
A. U.S. DLF 125§	$ 0.4	
B. K.F.W. West Germany¶	DM 4.0	5%

* The interest rate on UK loan depends on UK Treasury rates. Here it has been calculated at 7.125% which closely resembles the UK Treasury rates.

† Of the US Aid Loan, Loan No. 367-003 is to be repaid in US dollars, and loans No. 367-004 and No. 367-006 are to be repaid in Indian Currency at the exchange rate prevailing at the time of loan disbursement.

‡ The US EX-IM Bank loan is to be repaid in Nepalese rupees at the exchange rate prevailing at the time of repayment.

§US DLF 125 loan is to be repaid in Nepalese rupees at the exchange rate prevailing at the time of repayment.

¶ This loan is to be repaid in DM. It was extended by the *Kreditanstalt für Wiederaufbau.*

Source : Department of Research and Statistics, Nepal Rastra Bank.

Second Plan have both foreign and internal loans started to be taken. Table 5:2 shows the extent of the external loan, and the rate of interest.

Economic development is a process which needs the active participation of the private sector also. With a view to encouraging private industries—either by installing new industries or promoting the existing ones—table 5:2 shows that the Government has also been a guarantor.

The amount of external loans during the Second Plan was estimated at Rs. 28 million directly, and in addition a Rs. 18 million external loan was provided to NIDC, with the Government as guarantor. For the Third Plan it was estimated to be Rs. 200 million from various sources, but experience of the first four years of the Plan shows that the actual figure will be much less than the original estimate.

INTERNAL BORROWINGS

Public borrowing as a fiscal device is increasingly being adopted by developing countries, after the stage has, more or less been set for its floatation for financing schemes of various types in the public sector. There is one opinion that public borrowing, as a method of financing development activities has even certain advantages over taxation. It mobilises a substantial part of the public's voluntary savings and makes it available for development plans without generating any inflationary tendencies in the economy. Obviously, taxation when it is pushed beyond a certain limit, gives rise to certain disincentives, while public borrowing does not. It goes without saying that public borrowing, like taxation, restricts present consumption by effecting the transfer of resources from present consumption to investment, but it may not produce any unfavourable effect on incentives, partly because of its voluntary nature and partly because of the expectation of repayment on the part of those who subscribe to it. Therefore, it is important that the development of the country should have reached a stage where people have confidence in the Government as regards the repayment of the loan, along with the principal capital. In advanced countries, however, especially during a period of depression, increase in public expenditure financed through borrowing plays an important part, even though it may

not produce any productive capital asset, because it gives rise to stability in the economic system by creating a larger volume of employment. This demand-generating view advanced by Keynes is very important, once the state assumes to itself the responsibility for maintaining economic stability. But in the case of a developing country, as one UN Report rightly emphasises: "Taxation should cover at least current expenditure on normal government services. Borrowing is particularly appropriate to finance Government expenditure which results in the creation of capital assets, or which is otherwise directly productive."[5] It is appropriate that, until government policy offers an indication that fiscal policy is, and is likely to continue to be, soundly based, the chances of the public subscribing even to a small-interval loan must be considered remote. That is why even the document of the First Five Year Plan confessed: "Some time is required for suitable preparation in order that the country's first such bond floatation may be successfully carried out."[6] In a similar way the floatation of internal development loans also started from the fiscal year 1963/64 when, for the first time, loans worth Rs. 13.1 million were floated, of which more than 60 per cent was subscribed by private individuals. The second and third loans were also simultaneously floated in the following years. In March 1966, the Government floated the third series of development bonds amounting to Rs. 7.5 million, carrying the interest rate of 7 per cent per annum with a maturity period of ten years. In June 1968, another series of development bonds amounting to Rs. 10 million was issued. Table 5:3 takes into account the bonds floated so far. The development bonds outstanding as at mid-July 1968 total Rs. 51.2 million. This includes forest, and land compensation and a prize bond.

On the basis of both internal and external loans, it will be seen that, for the economic development of the country during the past few years, internal resources have been progressively mobilised and the Government, by cutting down its regular administrative expenses, has been able to contribute progressively to the financing of development activities. It is notable that, until quite recently, aid in the form of grants, by the developed

[5] United Nations, *Domestic Financing of Economic Development*, New York, 1958, p. 8.

[6] Government of Nepal, *First Five Year Plan*, Kathmandu, 1956, p. 15.

TABLE 5 : 3

INTERNAL LOANS

(In Millions of Rupees)

Loan	*Amount*	*Interest Rate*
A. Development Bonds		
(i) 1963/64	13.1	6%
(ii) 1964/65	7.5	6%
(iii) 1975/76	7.5	7%
(iv) 1974/75	10.0*	7%
B. Prize Bond	2.5†	—
C. Compensation Bond		
(i) Forest	5.6	1%
(ii) Land	5.0	3%
Total	51.2	

* Development Bond of Rs. 10.0 million was floated in June 1968.

† In 1966/67, a prize bond worth Rs. 0.7 million was sold out, the rest being on sale in the following year.

Source : Department of Research and Statistics, Nepal Rastra Bank.

countries particularly on a bilateral basis, has been playing a very significant role; but with more emphasis on multilateral aid by a number of developed countries, grants-in-aid are gradually becoming less important and aid in the form of loan is becoming more important. Obviously, with this trend, long-term debt servicing will become a problem quite inextricably connected with the rate of economic development in Nepal.

According to present indications, the sources of debt servicing in Nepal include: the cash surplus of the revenue part of the budget, other internal sources including the dividend available to the Government from public enterprises, foreign aid and grants.[7] Under the land reform measures started in 1964, a scheme for compulsory savings by the landowners and tenants in kind has, additionally, been implemented. This has obviously aroused widespread interest in the sphere of capital formation

[7] For details, see my article, 'The Problem of Debt Servicing in Nepal' in *The Financial Express*, Bombay, February 8, 1968.

for agricultural development. In three years about Rs. 150 million could be collected. Of course, the main purpose of all such loans has been to plough back such savings into agricultural development. Still these give rise, from a longer standpoint, to some obligations on the part of the Government. Therefore, the main difficulty now lies in the fact that an institutional structure, capable of properly channelling these savings into useful investment, has not yet been perfected. An experiment is under way in Bhaktapur district in the Kathmandu Valley to establish the process by which compulsory savings can be used to create a cooperative credit and marketing system oriented to the needs of the tiller in each district. This needs to be gradually expanded with a view to proper utilization of all savings.

TABLE 5 : 4

DEBT SERVICING (FOREIGN) AS PERCENTAGE OF ANNUAL FOREIGN EXCHANGE EARNINGS

(In Thousands of Rupees)

	1963/64	1964/65	1965/66	1966/67	1967/68	1968/69
1. Foreign exchange income	60,881	70,290	1,00,050	1,22,780	2,11,149	1,22,761
2. Interest on borrowings	178	384	456	539	1388	188
3. (2) as percentage of (1)	0.3	0.5	0.5	0.4	0.7	0.2

Sources : (1) Department of Research and Statistics, Nepal Rastra Bank.
(2) The figures for 1968/69 are for only 6 months.

It will be clear from Table 5:4 that external loan has not at present assumed any serious problem of debt servicing; still, it is clear that in absolute figures, between fiscal years 1963/64 and 1967/68, interest on external loan increased by almost seven times. As a percentage of annual foreign exchange earnings it has also gone up, but very slowly. For the fiscal year 1967/68 the actual rate of increase being less than 1 per cent, and still less for the year 1968/69. Though the figure does not provide for capital

payment, if all is included this becomes quite substantial; for example, in Pakistan between 1960/61 and 1966/67 it is estimated to have gone up from 3 per cent to 18 per cent of annual foreign exchange earnings. Compared to this, Nepal's position is modest. However, in the years ahead, the amount might accumulate with the increasing emphasis on long-term loan, under which capital payment will have to be large. From a longer standpoint, both for external and internal debt servicing, some important source will have to be projected without further delay. First, it would be highly desirable if, right from now, a greater cash surplus in the revenue part of the budget could be generated by the Government; secondly, the Government-owned industries which are either completely public or semi-public should be properly managed. There are problems of differing importance: for example, some of the industries in the public sector—particularly all those installed by foreign aid and operated in the public sector as mentioned above—are not working efficiently, and there is a long way to go. Inadequate availability of raw materials and other facilities, lack of efficient management, shortage of working capital and marketing difficulties are some of the factors militating against the achievement of an optimum rate of production. These factors will therefore have to be improved during the coming years. Thirdly, aid in grants can help in the process of debt servicing; however, in the years ahead its effectiveness is very limited, because developed countries are shifting to longer-term loans and fewer grants.

TABLE 5 : 5

INTEREST AS A PROPORTION OF REVENUE

(In Millions of Rupees)

	1963/64	1964/65	1965/66	1966/67	1967/68	1968/69 (Revised Estimates)	1969/70 (Estimates)
1. Total Revenue	157.9	192.3	216.5	256.7	326.0	400.2	442.3
2. Interest on Government Debt	1.0	3.6	2.3	4.7	3.4	5.9	7.1
3. (2) as percentage of (1)	0.6	1.9	1.1	1.8	1.0	1.4	1.6

Source : HMG's Budget Speeches.

Table 5:5 gives some idea of the annual ratio of interest to the total revenue. Even if the percentage has gone up from 0.6 in 1963/64 to 1.6 in 1969/70, the rate of increase cannot be regarded as phenomenal. In fact, in a developing country, the national debt may amount to a small percentage of the national income, and this is adequately justified in a country like Nepal where the private sector has yet to evolve in the real sense. Since, owing to the low standard of living, voluntary savings are at a low level, the possibility of using public borrowing as a fiscal instrument also is confined to a narrow limit. The low voluntary savings among the general mass of the population cannot possibly be increased significantly over a short period. Although, to achieve economic development, it is necessary for the Government to continue to have a loan policy (both internal and external), the servicing, even with the increasing process of resource mobilisation through taxation measures, will create an important problem.

As the economic development process advances, the problem of debt servicing will have to be carefully considered from time to time, and appropriate measures taken. Of course, this is a problem which needs to be studied by the country or international organisation which provides assistance to the developing country; and it also has to be solved by the individual recipient country itself. From the standpoint of the developed countries, "a reformed international trade mechanism can gradually promote the rapid expansion of export from developing countries."[8] This would imply, in addition to other things, lower or even no tariff walls by developed countries on the imports of primary products from developing countries. Secondly, loans with softer terms should be encouraged not only by the multilateral agencies such as the IDA, but even the individual developed countries should try to advance loans at softer terms. More recent experiences have shown that the loans from the United States have been getting softer in many cases, while the loans from Japan, West Germany and a number of western countries have still remained comparatively hard, even if interest rates charged have been slightly lower than the commercial market rates.

[8] J. Bhagawati, *Economics of Underdeveloped Countries*, World University, London, 1968, p. 219.

CONSISTENT EFFORTS FOR SELF-HELP

Generally speaking, constant efforts by the developing countries should be directed to the following aspects. First, maximum possible efforts should be made to mobilise internal resources other than merely internal loans. In other words, consistent efforts should be made to mobilise resources for development through taxes. Secondly, the external trade sector should be gradually expanded by increasing the production of the country. These aspects need to be properly taken into account by Nepal while formulating its future economic development policies. This would even necessitate some changes in the existing strategy of agricultural planning. One can suggest that, to boost agricultural production, a resource approach or farm-to-farm approach might be better than planning by fixing physical targets, in the absence of reliable agricultural data.

AID AND LOAN NOT SUBSTITUTE FOR DOMESTIC RESOURCES

Finally, although foreign assistance is an important constituent in the present capital inflow in the developing countries, it can, by its very nature, be only a temporary palliative and one which is limited in scope from a long-range approach, even if the total combined contribution of all the developed countries reaches one per cent (it is now much less) of their combined national income. In fact, the old idea of foreign aid as a temporary measure, with emphasis on short-term objectives, is now almost out-of-date, and today most developed countries advance long-term aid to developing countries for long-term development plans. Loans with easier terms of payment are being granted, as mentioned above, both on a bilateral and a multilateral basis. However, even from the budgetary angle, when large sums have to be found each year for servicing debts (from a longer perspective) it is particularly hard to further squeeze the already low levels of consumption to provide for debt servicing in addition to new capital investment.[9]

All this forces our attention to the fact that economic development of any developing country should, above all, be based on the process of maximum mobilisation of potential domestic

[9] See for details, my article 'Both Aid and Trade' in *The Eastern Economist*, New Delhi, July 12, 1968.

resources. Of course, such a policy approach does not, by any means, rule out the utilisation of foreign aid. However, in a growing economy, there cannot be much choice between taxes and loans to finance development. All resources will have to be tapped, within the given context, in order to meet the demands of the economy. In that sense, loans are as necessary as taxes, but on a comparison of the economic effects of the two, from the long-term point of view taxes are better than loans, since, other things being equal, taxes do not create a problem of repayment of interest on capital, whereas loans do. In any case, aid and loan are not a substitute for taxes.

6

FISCAL POLICY AND ECONOMIC DEVELOPMENT

Economic development is essentially a long-term process and involves structural changes of a rapid and far-reaching character. In most countries, development is accomplished through planning, 'which provides a logically integrated framework for taking a whole set of such decisions and the techniques of planning furnish tools for the translation of policy objectives into specific tasks and programmes of action.'[1] In developing countries, generally speaking, the evolution of the private sector having reached only a low level, integrated planning entails some sort of conscious control and direction over resource allocation, in order to ensure that original priorities are properly implemented, and even that the public sector has to undertake some of the entrepreneurial activities. Thus the government budget can reflect, within the given policy framework, the comprehensive character of the management of the economy, and absorb and redistribute a large share of the economy; a close relationship will have to be established, on a co-ordinated basis, between planning and budgeting.

Hence in modern times, the primary task of fiscal policy in developing countries is increasingly to raise the ratio of savings to national income in the context of planning. Such savings, generated through well-devised policy measures, should succeed in making available a larger flow of resources for economic development. Today, the Keynesian approach of short-run growth has

[1] United Nations, *Economic Bulletin for Asia and the Far East*, New York, September 1966, p. 1.

been replaced by Harrod and Domar models of steady growth, particularly in developing countries. As analysed in the introductory chapter, in recent years, on an analysis of conditions for long-run equilibrium in a dynamic economy, the possibility of the emergence of long-run disequilibrium has been pointed out, calling for a shift in emphasis in the objectives of fiscal policy.

OBJECTIVES OF FISCAL POLICY

In broad terms, the main objectives of fiscal policy should comprise the following features. First, there should be consistent efforts to increase the rate of investment by adopting measures which are inducive to restraints on potential consumption; secondly, the Government should take both direct and indirect measures to encourage the flow of investment into channels which are judged to be the most desirable from the point of view of society; thirdly, as one expert suggests, "where large inequalities of income and of wealth exist, the distribution of income and wealth should be modified in a manner and to the extent that are consistent with the best long-term interests of the population as a whole."[2] Since, under the conditions of a developing economy, fiscal policy should be directed to increasing savings and investment both in the public and private sectors combined, this obviously postulates a well-balanced development programme. Under the circumstances, the main task of the Government should be to finance large and growing government expenditure in an orderly, efficient, and fair manner. This also involves greater budgetary savings for development finance, finding large and growing amounts of tax revenue and so on.

Within the existing limitations of the underdeveloped framework, as analysed in the preceding chapters, Nepal's fiscal policy, more particularly after 1960, has been undergoing a process of refinement,[3] and efforts have increasingly been made to utilise the fiscal weapon, within the given limitations, as an instrument for economic development.

[2] Raja J. Chelliah, *Fiscal Policy in Underdeveloped Countries*, Allen & Unwin London, 1960, p. 52.

[3] It is notable that, in the course of one particular year even if there has been no tendency to deficit financing from the fiscal angle, price rises have been quite substantial.

During the last few years, as explained in the above chapters, persistent efforts were made by the Government to restrain regular expenditure and contribute the savings thus generated to development activities. However, such a policy, as evidenced from recent trends, is dependent not only on cutting down the government's regular expenditure to the utmost minimum but also on increasing revenue. The present chapter seeks to focus on how far Nepal's fiscal policy which is oriented to the above objectives, is compatible with our conditions, and how far fiscal policy can contribute to economic development.

INTERNAL CONTRIBUTION TO DEVELOPMENT

In the First Five Year Plan, 16 per cent of the total outlay was originally expected to come from domestic sources; in effect, almost complete reliance had to be placed on foreign aid. This is seen from the regular parts of the budget, which were financed by cash reserves and other measures of deficit financing. However, with growing experience and other improvements during the Three Year Plan, internal resources could be mobilised to a greater extent than had been originally estimated. The percentage share of internal resources came to be 25 per cent as against the target of 17 per cent of the Plan's total outlay. Thus the share of the Government's surplus budget in development expenditure reached Rs. 107.0 million, as against the estimates of Rs. 50 million. As a result of the adoption of the austerity measures in public expenditure, as mentioned above, the expenditure on

TABLE 6 : 1

SURPLUS IN THE REGULAR PART OF THE BUDGET

(In Millions of Rupees)

	1963/64	1964/65	1965/66	1966/67	1967/68	1968/69 (Revised Estimates)	1969/70 (Estimates)
1. Total revenue	157.9	192.3	216.5	256.7	326.0	400.2	442.3
2. Surplus	43.6	74.4	69.2	86.1	145.2	198.7	209.5
3. 2 as percentage of (1)	27.4%	38.7%	32.4%	33.5%	44.8%	49.6%	45.1%

Source: HMG's Budgets.

the regular side started gradually coming down. This is clear from the trends of revenue in Table 6:1.

In fact, during the current Five Year Plan it is estimated that almost 50 per cent of the total outlay will be met by internal resources, whereas in the Second Plan the proportion was about 24 per cent. The experience of the first four years is quite encouraging in that, while it was envisaged that Rs. 75 million would be made available from internal contribution, almost more than Rs. 100 million are estimated to have been so far generated as surplus for development finance. Of course, it is very difficult to estimate the extent of restraint on consumption in the private sector due to the fiscal policy; still, the initial tendencies seem to promise well.

However, the table below indicates that the recent trends in government expenditure on the regular part of the budgets have been somewhat erratic in the sense that, in spite of curtailment of expenditure, it has been going up. It seems necessary that a more sustained effort should be taken in this regard, and a consistent policy adopted. For example, during the fiscal year 1965/66, resulting from the faster rate of growth in expenditure than in revenue, the regular expenditure increased by 25 per cent compared with the previous year. In the same year, although in absolute terms revenues increased considerably, the rate of increase slowed down from 28 per cent to 13 per cent. It is impor-

TABLE 6 : 2

TRENDS OF REGULAR EXPENDITURE

(In Millions of Rupees)

Fiscal Year	*Total Expenditure*	*Increase in amount over the previous year*	*Increased by percentage*
1963/64	114.0	–	
1964/65	118.0	4.0	4
1965/66	147.3	29.3	25
1966/67	170.6	23.3	16
1967/68	180.8	10.2	5
1968/69			
Revised Estimate	201.5	20.7	11
1969/70 Estimates	232.8	31.3	15

Source: HMG's Budget Speeches.

tant that the regular expenditure normally should not increase by more than 5 per cent every year.

NEED FOR INCREASE IN REVENUE FROM AGRICULTURE

Only after 1960 was taxation policy initiated with the object of contributing on a coordinated basis to the socially most beneficial pattern of investment. Of course, in the absence of a genuine evolution of the private sector, there have been constraints on the implementation of such policy measures of the Government.

Developing countries, in general, have a high proportion of their population (between 90 to 60 per cent) in the subsistence agricultural sector compared to 10 per cent or less in the highly developed countries. Experience has taught us that the agricultural sector does not respond to economic incentive in the same way as industry or commerce. The general poverty and the prevalence of self-employment are major reasons why a low percentage of population comes under the tax net. Hence, in the process of development, additional taxes levied on the agricultural sector help in generating additional funds for financing economic growth. Countries like the Soviet Union and Japan resorted to such heavy dependence on agricultural taxation in order to enlarge the supply of necessary savings required for the country's economic development. In Nepal, even though land revenue today accounts for about 20 per cent of the total domestic revenue, the rate fixed forty or fifty years ago was in existence till quite recently, though some adjustments were made in more recent years. As already explained, land revenue is levied at a flat rate with no exemption limit. Thus the burden is too heavy on the petty agriculturist. This makes it necessary that the system of land taxation should be reformed so that it becomes a progressive and equitable tax. So far, the tax has been inelastic and the revenue from it does not expand with an increase in prices or in the output from land.

Technically, it is revised only after a re-settlement which involves a detailed cadastral survey. Although, as discussed in Chapter 3, in recent years the Government made some adjustments, the burden of land revenue could not have been increased, even the price of agricultural produce had risen to four to five times the pre-war level. Of course, flat increases in the pre-

sent rates will normally cause anomalies between what various pieces of land pay by way of tax corresponding to those already existing. True, the process of land reform by phases has also helped in giving relief to agriculturists; however, the revenue has not been rising on a proportionate scale. The cadastral survey in all the districts should therefore be completed as early as possible, and on that basis standard rates should be fixed for the various classes of land and these should be applied, as early as possible. It is also suggested that 'the basis of land revenue should be the area of the land, production and existing prices.'[4]

Again, it is generally thought that, because of the improvements in agricultural performance which have added substantially to disposable incomes in the hands of surplus farmers, and because the Government has invested large amounts in agriculture, very little has flowed back to the exchequer from this sector. However, while the land revenue was increased in July 1966, tax on agricultural income was completely exempted. How to tap the sizeable tax potential from agriculture is a very important problem to all the finance ministers. It has been suggested that agricultural income tax can be levied after isolating it from direct taxation on economic and administrative grounds.[5] But the costs of collection and administration of farm income-tax would be disproportionately heavy, considering the widely scattered distribution of potential assesses; also the level of farm income that should attract tax has to be determined with reference to factors like the lack of keeping records of inputs by the farmers, difficulties in valuation of crops falling in different assessment periods, wide fluctuations in the prices and output of various crops, and the high cost of collection.

EFFECTIVENESS OF CUSTOMS AND EXCISES

Obviously, customs and excise duties are becoming increasingly important as sources of income. Such indirect taxes on imports and exports can be used as effective instruments of trade control, or to check a drain on foreign exchange resources. Customs duties will provide the largest source of revenue to the Govern-

[4] Economic Advisory Council, *Report on Land Revenue, Customs and Excise,* Kathmandu, 1968, p. 16.

[5] P. Chatterjee, 'Agricultural Income Tax' in the *Economic and Political Weekly,* Bombay, July 20, 1968, p. 1139.

ment with the increased trade. This trend will continue unabated and already today it accounts for about 40 per cent of total income. Excise also is becoming gradually important, contributing about 10 per cent of the total internal revenue. It is better to levy excise duties on a few commodities rather than on many unimportant commodities. This reduces the cost of collection and make administration more effective. From a long-range standpoint there seems to be reasonable scope for rapidly increasing the yield from customs duties. Of course, much depends on how effectively, in the context of our peculiar open border on three sides, customs administration can be strengthened in the coming years. With the increasing speed of industrialisation and expansion in the output of manufactured goods there is great scope for a further increase of excise. It is notable that in recent years the Government has been steadily exploring various ways of increasing revenue, and has started to increase consistently the coverage of excise taxation.

THE SALES TAX

In the fiscal year 1965/66, as explained in an earlier chapter, His Majesty's Government introduced sales tax on a very modest scale, exempting basic food materials, reading and writing materials and medical articles. This is the simplest form of sales tax. It is assessed on the sales turnover of a dealer and collected from that dealer; it can better be called a selective sales tax, as only certain selected goods have been brought under its purview. It has a single-point system, since the tax is levied at only one stage. The relevant Act lays down the minimum value of turnover which will make a dealer liable to payment of the tax. Since the tax has only recently been imposed for the first time, estimates of its yield could not yet be very scientific, but it can certainly develop into a distinct and useful form of taxation for the future. Obviously, excise and sales taxes, if properly formulated, do not only raise revenue, "especially from those who cannot be reached through direct taxes, but also can curtail the consumption of luxuries, and restrain a rapid increase in mass consumption of non-necessaries."[6]

[6] Raja J. Chelliah, *Fiscal Policy in Underdeveloped Countries*, George Allen and Unwin, London, 1960, p. 145.

TABLE 6 : 3

TAX REVENUE AS PERCENTAGE TO TOTAL REVENUE

(In Millions of **Rupees***)*

	1961/62	1962/63	1963/64	1964/65	1965/66	1966/67	1967/68 (*Revised Estimates*)	1968/69 (*Estimates*)	1969/70
1. Total revenue	91.0	129.6	157.9	192.3	216.5	256.7	326.0	400.2	442.3
2. Tax revenue	2.1	3.7	5.5	7.4	16.4	24.8	44.2	64.5	69.3
3. 2 as percentage of (1)	2.3	2.4	3.4	3.8	7.6	9.6	13.5	16.1	15.6

TAXES ON INCOME AND WEALTH

Progressive taxation in the form of taxes on income and wealth is important as a deliberate corrective to spontaneous economic forces which produce steadily growing inequality. Until the fiscal year 1959/60, there was no tradition of imposing direct taxes like income tax. The revenue from taxes like urban property tax, business profits tax and revenue surcharge, introduced in the fiscal year 1959/60, did not come up to the original estimates owing to faults in collection. However, in more recent years, the collection has been speeded up. The percentage contribution of all taxes to the total domestic revenue as shown in Table 6:3 has increased from 2.3 per cent in the fiscal year 1961/62 to 15.6 per cent in the fiscal year 1969/70.

Gradually, the yield from the income tax can also be increased quite significantly, both by effecting necessary improvements and slowly extending it to cover new categories of income. Taxation is a matter of habit, and in our country, in the context of both the tax administration and the attitude of tax-paying public, it cannot be raised all at once without buying some time over the next few years. However, the increased tax revenue, as shown in Table 6:3 is encouraging. Over future years, it can become one of the major sources of revenue with a further improvement in tax administration and of social attitudes regarding payment of taxes on the part of the people.

However, in an emerging country, enforcement of income tax is difficult except where family incomes are received as payments for service or output, and the family keeps some records. Thus in practice few families in a subsistence economy can be taxed. It is, generally, corporations, self-employed professionals, and salaried employees that can most economically be taxed. With the development of the national economy, these become relatively numerous, but even so the Government should try to avoid an impossible administrative burden by introducing some sort of generous exemption scheme.

Our review of some representative taxes in Nepal shows that, judged in perspective, certain favourable trends have become perceptible even over a short period. Even modestly stated, some of the taxes, particularly new taxes, have shown an upward trend within a few years of their inception. Measures have also been

taken to increase the yield from indirect taxes substantially, both by gradually introducing new taxes and by making the collection more effective. It is, of course, necessary that the structure of indirect taxation must be properly fashioned in order to achieve certain important objectives. These comprise the process of raising revenue particularly from those who cannot be reached through direct taxes. In fact, taxation is a matter of co-operation between the tax administration and the tax-payer.

TAX BURDEN

In comparison to other countries, the tax burden in Nepal is still quite small i.e. the country receives in revenue only about 7 per cent of the estimated national output. In Ceylon 22 per cent of the national income is taken by way of taxation, in Burma the figure is 19 per cent, in India 16 per cent, in Pakistan 12 per cent, in the Philippines 10 per cent, and between 20 to 30 per cent in developed countries. Even if the country's fiscal administration in the last few years has undergone some improvements, we have cause for dissatisfaction. As mentioned above, to meet the needs of the growing economy, more consistent efforts to widen revenue sources are necessary. Needless to emphasise, taxation can provide the means of generating internal savings, to supplement the external aid for the large projects, which is needed both to attain not only higher productivity in industry and agriculture, but also educational, social and cultural facilities for the majority of the population.

TAXES AND PRICE POLICY

In Nepal in recent years, in spite of counter-inflationary fiscal measures, there has been a rapid monetary expansion.[7] For example, during the Second (Three Year) Plan period, prices increased by more than 26 per cent. The unweighted national price index (with base 1961) increased by 9.1 per cent in 1965/66, as against rises of 14.0 per cent in 1964/65 and 9.4 per cent in 1963/64. Therefore, in the years ahead, monetary expansion and strategic planning require a reduction in private consumption

[7] This aspect has been fully discussed in one of the following chapters.

through additional taxation. It is necessary for the people to realize that reducing disposal incomes through taxation is a more sensible method of bridging the inflationary gap, than reducing the real value of incomes through rising prices. Of course, in the initial stages, the attainment of this approach becomes hazardous and time-consuming process. It is very important that other related measures should also be properly taken into consideration.

Any proper evaluation of physical aspects of planning and the fast expansion of export trade are also inextricably connected with the process of resource mobilisation. However, unless enduring remedies are undertaken, the yield from a typical revenue system does not generally keep pace with increase in prices, and thus in a state inflation the financial position of the government might gradually worsen. To obviate this trend, a change in long-term planning strategy, with a greater bias towards agricultural production, is necessary. In view of Nepal's topographical features and other administrative difficulties in the way of agricultural development, an approach to resources planning can be adopted in place of the conventional strategy of target fixation. To hold the price line, indirect taxes can often be better relied upon in those cases where it is necessary to make some sort of intervention to adjust differences between marginal private and marginal social net products. As Professor Holzman has suggested, "The ability to equate supply and demand by commodity tax as well as by adjustment to output allows the planners considerably more freedom from consumers' interference than would be possible if income tax were the sole available fiscal instrument."[8] In the Soviet Union, commodity taxes have provided the bulk of national revenue. In Japan, between 1880 and 1913, indirect taxes on consumer goods largely financed the growing requirements of the national budget. In Nepal also, where recent economic development has been undertaken on a planned basis and regulation of prices in the public interest has become indispensable, the importance of commodity taxes cannot be minimised.

DIRECT AND INDIRECT TAXES

In spite of the fact that very big taxes cannot be raised from very

[8] F. D. Holzman, 'Commodity and Income Taxation in the Soviet Union,' in *The Journal of Political Economy*, October 1950.

poor people, Nepal's experience has shown that, for a government to assess and collect revenue, the overall confidence of the tax-paying citizens has first to be generated. The tax-payer's resistance to suffering cuts in his income is conditioned by various factors such as low per capita income, lack of development consciousness and psychological and political effects inherited from past times. This His Majesty's Government has been able to generate gradually. With greater experience and with the progress of time, improvements may well occur in all these fields.

All such conditions prompt us to ask why, in a country like Nepal, indirect taxes have to play an important role in the fiscal structure. With the low income of the people, it is very difficult as well as expensive to administer direct taxes. Since indirect taxes are usually camouflaged in the price of a commodity, the tax-payers do not feel the incidence, psychologically. From the revenue angle, with the increase of trade and the development of industry, the yield from customs and excise duties has a tendency to rise. Even if the Gross Domestic Product under the periodic plans will be doubled by 1980, the income of most of our people would still be too low to be taxed directly. But with the growing demand for social investment and rising government expenditure, from a longer range it becomes almost inevitable that the tax authorities in Nepal must look to the day when they can develop an efficient system of direct taxation—some form of an income tax in combination with taxes on capital gains, wealth and gifts.

However, as in any other less developed country, the fiscal problems of Nepal in spite of the adoption of new measures, are too complicated on account of its own unique historical antecedents and institutional and social structure, to be solved in a given period, and so the country has been prevented from developing as rapidly as it otherwise might. The same situation will continue. Of course, in recent years there has been fiscal restraint, particularly as regards pruning down regular expenditure. Relatively speaking, additional revenue could also have been generated much faster. Still, in spite of an upward trend in revenue, the prevalence of mostly specific indirect taxes—i.e., heavy dependence upon customs duties, rendered comparatively stagnant by balance of payments limitations on import growth, and low land tax based on long-outdated assessments—has inhibit-

ed revenue growth. Therefore, with revenue collection efforts backed by simple and improved tax administration, fiscal policy should be made more broad-based, and the quest for additional revenue should be consistently encouraged and should be the most appropriate for accelerating economic development in the context of the mixed economy.

As explained above, in a poor country like Nepal, even for many years to come, indirect taxes will have to play an important role in the fiscal structure. The experience of the last few years has shown that the incidence of taxation on rural income in Nepal has been lower than that in the urban sector. Therefore, it is imperative that there should be better performance in the rural sector, which is conditioned wholly by the progress of indirect taxation on rural areas and not by the increase in direct taxes. The object of the Government has been not to become a monolithic organization controlling all avenues of investment and employment, but to fill up the gaps left by private enterprise, and this, in principle at least, has been a step in the right direction in the present context. Effective progressive taxes can have significant distributive effects which will influence not only financial relationships but even the social structure as such.

However, it should be properly understood that the cumulative burden of both direct and indirect taxes can adversely affect the saving capacity both of individuals and the corporate sector, and the capital market—if there is any nucleus of this nature—which depends upon a large number of small investors, cannot exist unless adequate incentives are provided to individuals to save and invest. Therefore, from the growth angle, there is also a strong case for lowering the rates of taxation at various levels, since in cases (for example, import duties, or even income tax in our conditions) this action will substantially minimise tax avoidance and tax evasion, and make for larger yields without in any manner affecting the revenue requirements of the Government. Therefore, it is always imperative that, even with the low percentage of taxation in Nepal, a balance will always have to be struck between direct and indirect taxes, and any fiscal policy would require a basic reorientation with a view to solving the paramount problem of stepping up the rate of growth, by stimulating and assisting production increase and curbing the rise in prices by countering inflationary pressures.

FISCAL AND MONETARY POLICY

The efficiency of the fiscal policy in a developing economy becomes all the more important, because of the non-existence of a sophisticated money market and other ancillaries. In a country like Nepal, the pre-dominance of the non-monetized sector greatly limits the scope of fiscal as well as monetary policy. Fiscal policy, as we have seen, involves a direct draft on the financial resources and purchasing power in the hands of the public, and, with particular classes, through use of a variety on income and commodity taxes, while monetary policy in contrast only influences the cost of availability of credit, which cannot be for all practical purposes a similarly potent weapon. Also the ability of taxation to differentiate between the circumstances of different classes of producers and consumers with reliefs and rebates and investment allowances of various kinds, or through commodity taxes, is much more effective than Central Bank action in allocating bank credit. Thus, it appears that the role of monetary policy should be recognised as subsidiary to fiscal policy in a developing country, though it goes without saying that, with the rapidity of economic growth, monetary policy can also become increasingly effective. However, this certainly does not mean that monetary policy has no efficacy in the context of the overall development. The following chapters will attempt to analyse the necessary ancillaries in the field of monetary policy.

The Central Bank is the main agency for the mobilisation of savings, and stability is an important objective of banking. However, in a developing country, as Prof. Hicks suggests, "where the financial infrastructure is only in the course of erection, where banking habits only touch a minor part of the economy, the contribution that a central bank can make to development is more important and immediate than what it can do in the way of stabilisation."[9] The changes of function that have occurred among the central banks over the last century indicate that monetary policy has extended its scope. Some of the more important issues connected with these aspects will be discussed in the following chapters.

[9] Ursula K. Hicks, *Development Finance,* Oxford, 1965, p. 55.

PART II

MONETARY ASPECTS

7

CENTRAL BANKING AND MONETARY POLICY

In the first part of the present study, major discussion was devoted to the working of fiscal policy in the process of economic development in Nepal, which is still fundamentally at a very early stage with regard to budgetary formulation and implementation. It was emphasised that, in development strategy, which needs to raise the rate of savings and thereby increase the level of investment, monetary policy also has an important role to play, without the existence in the absence of a sophisticated money market in the western sense. From 1956 onwards, with the gradual development in the economy of a number of financial and development institutions, the effective range of monetary policy has also been gradually expanding.[1]

In this part of the study, since monetary policy falls within the domain of the Central Bank, other things being equal, analysis on the basis of Nepal's recent experience has been primarily devoted to the working of the Nepal Rastra Bank and the contribution that it is able to make to development in general. This has been followed with an appraisal of the main ancillaries in the field of monetary policy, though in all cases the contribution of the Central Bank is kept in view. Such aspects in general deal with the commercial banking, other institutions dealing with long-term finance and development, the exchange rate as a stabilising factor and the overall efficacy of monetary policy in the growth context.

[1] See Chapter I, p. 10.

CHANGING CONCEPT OF MONETARY POLICY

Although the theory of monetary policy has been a subject of great controversy ever since the end of the First World War, it became much more controversial after the Second World War, although broadly there is much agreement. "A flexible monetary policy, primarily designed to operate through flexible interest rates, was inherited from the pre-1914 era of small budgets, small government debt, a simple pattern of economic organization and of only one or two important international financial centres."[2] This approach, in a very limited sense, is still applicable to the monetary issues of a country. But in view of the changed situation of modern times even in a developing country, the ideas of neo-classical economists favouring a general asset-preference theory, in which money was only one of the assets, could not solve any problem. This became increasingly evident in the Depression of 1929 when, not only was monetary policy ineffective in preventing prosperity from breaking down, but it proved to be completely unable to bring about any reflation of prices or a restoration of prosperity in the 'thirties.

After the Second World War, therefore, monetary policy was fundamentally re-oriented, even in developed countries. Greater emphasis was placed on such weapons as open market operations and selective credit control. "The instrument of self-liquidating bill of exchange for financing external trade was replaced by commercial credits on open account and bank advances on current account or overdrafts. As an outlet for short-term investment the bill of exchange was replaced by the Treasury bill."[3] Even long-term capital gradually came to be dominated by government securities, for whose stability continuous central banking support became imperative. There has also been a change stemming from the increase in Government debt, and this has been more or less instrumental in arousing the public's emphasis and insistence on the 'security of a bond' rather than on its yield. Such developments, more particularly the large-scale establishment of specialized financial institutions, have been responsible for introducing

[2] Ervin Miller, 'Monetary Policy in a Changing World', in *Quarterly Journal of Economics*, February 1956.

[3] J. D. Sethi, *Problems of Monetary Policy in an Underdeveloped Country*, Asia, Bombay, 1961, p. 71.

rigidity in the movements of short rate and its relation with long rate.

However, the role of monetary policy for an underdeveloped economy is made difficult not only because of the lack of general theory for such an economy, but because of the absence of a number of conditions available in the developed countries and the over-all supremacy of the non-monetized sector in the economy. An expert has given a correct picture in these words: "What really persist are small variations in their extremely low level of incomes, employment and capital formations—all moving in a vicious circle."[4] Obviously, the crucial task is not merely to prevent stagnation, and break the vicious circle, but to break through it by deliberate and dynamic growth of these economies. Towards that end, both fiscal and monetary policies should work hand in hand with each other.

SCOPE OF THE POLICY IN NEPAL

Against the background outlined in the previous section, one can look at Nepal's problems. Monetary policy, in general, influences the cost of availability of credit, which, under conditions like those of Nepal, cannot in the overall context be a potent weapon. In the post-war period, the role of monetary policy in relation to planned development through maintenance, in general, of monetary discipline has been increasingly recognised. The last two decades have witnessed the expansion of the activities of the Central Banks in a number of developing countries and, as a matter of practice, have been remarkable for the gradual evolution of new techniques of banking control. The Central Banks came to be concerned with the liquidity position of the entire economy and the stability of the price level; however the scope of monetary policy in a country like Nepal is influenced by two basic features of the economy which distinguish the country's situation from that of an advanced economy. First, with a large non-monetized sector, the currency as the medium of exchange cannot play a dominant role. This, in turn, makes the scope for multiple expansion of credit much less effective than in

[4] R. Nurkse, *Problems of Capital Formation in Underdeveloped Countries*, Basil Blackwell, Oxford, 1958, p. 4.

the developed countries. Secondly, in the existing conditions where bank deposits form a much smaller constituent of the monetary circulation, the ability of the central bank to regulate monetary conditions effectively is also correspondingly curtailed. However, even under the existing conditions, "although the establishment of a central bank which, *as in Nepal, is only thirteen years old* would not in itself create resources for economic development, it can assist in the channelling and the most economical utilization of a country's financial resources."[5]

BANKING DEVELOPMENTS

At this point, it will be relevant to review briefly how banking, along with certain monetary trends, has developed in Nepal over the past centuries. In the absence of reliable information, any such account can only be based on old chronicles, obscure details, inaccurate figures, some knowledgeable sources and so on.

The history of banking and currency in the country becomes definite only from the fifth century, that is in the Lichchavi period, when the first coins were minted. With the advent of the seventh century, coins of red copper started to be used for exchange purposes. Later on, during the twelfth century, in the wake of various reform measures initiated by the rulers, particularly during the Malla period, started the inscription of the kings' names and dates on the coins.

Necessary improvements were made gradually in the currency system, and by the end of the fourteenth century, during the régime of Jayasthithi Malla, one of the most lasting and effective reforms related to the codification of the laws regarding rights of property in houses, land and *Birta*. This reform, as one writer suggests, "has left a lasting impression upon the Nepalese nation of even to-day; and that it is from about Raja Jayasthiti Malla's reign onward that the granting of loans against immovable property must have been more commonly, if not newly, practised in the country."[6] Thus money-changing started as a profession on a wide-scale. The '*mohar*' coins (now called Rupees) appeared

[5] I. Obasanmi Olakampo, *Central Banking in the Commonwealth*, World Press, Calcutta, 1965, p. 51. (Author's italics.)

[6] B. D. Pant, *A Short History of Banking, Currency and Commerce in Nepal*, Kathmandu, 1946, p. 8.

only towards the last quarter of the seventeenth century. "One of the Sivasimha's inscriptions dated NS 711 bears for the first time an expression, *'tanka'* used for *'mohar'* coinage."[7]

Development of banking and currency became more consistent after the Gorkha conquest in 1768. On the eve of this event, the internal trade of the country was brisk, because consumer goods were more in demand and less in supply within the country. There was some trade through the Bhotia merchants of Tibet, the Gossains of Bihar and the Mohammadans of Kashmir. Even European merchandise seems to have been introduced into the country in the beginning of the seventeenth century, and to have found a market particularly in Kathmandu.

During the period from the sixteenth to the eighteenth century, refinements in the coinage and developments in indigenous banking were brought about gradually. Silver coins, for example, were brought into circulation for the first time. Dr. Regmi says: "Not only this, the fact of Nepal sending its coins to circulate in Tibet as legal tender shows the predominant position of this country in the internal and external economy of such contiguous areas outside its jurisdiction that extended beyond the high altitude of the Himalayas."[8] Such trends are indicative of the developments of currency and banking.

Even without the existence of banks of the modern type, in course of years individual indigenous bankers conducted some banking activities side by side with other occupations. The Tibetans, in the absence of an independent coinage in their country, freely used Nepalese *'Mahendramalli' mohars* which they called *'Indramalli'*, and used to send a large quantity of bullion to Nepal to be coined in the mint at Kathmandu. Another important event connected with coinage was that in 1768 King Prithvinarayan Shah recoined metallic coins on his accession to the throne.

In addition to all these activities, however, the money-changing business, though proving to be quite prosperous for a number of years from 1835 onwards, gradually started becoming sluggish for want of supply of the Muhammadan coins from India, where the newly standardised rupees drove them out of circulation. The prospects of profit in this profession having thus

[7] D. R. Regmi, *Medieval Nepal*, Part I, Calcutta, 1965, p. 533.
[8] *Ibid.*, p. 531.

dwindled, the *Sharafies* or money-changers received a severe set-back for about half a century.

In 1846 Shri Junga Bahadur, the first Rana Prime Minister, brought Nepal for the first time into contact with the Western world through his own visit to Europe and establishment of friendly relations with the British. Afterwards, during the premiership of one of his younger brothers Shri Ranodip in 1880, the *'Tejarath'* system of giving loans to the people of the Kathmandu valley at five per cent interest, against gold, silver and other ornaments, was established. At the same time, government servants also had the privilege of taking loans from this newly established office, repayable in instalments from their salaries at source.

In the overall development of the banking system in Nepal, the *'Tejarath Adda'* may be regarded as the father of modern banking institutions, and for quite a long time it rendered a good service to government servants as well as to the general public. Of course, it granted loans against bullion as collateral security; but it did not accept deposits, which probably was not considered then to be a function falling within the competence of banking. Even later on, with the evolution of some kind of systematic banking, the *'Kausi'*, or the Government's cashier office, had the primary responsibility of handling government accounts.

In such conditions, as in most of developing countries, even with the non-existence of a central bank, the first commercial bank of the country, that is, the Nepal Bank Limited, was established in 1937 as a semi-government organization, (the Government owning 51 per cent of the paid up capital) under a special Banking Act, with the elementary functions of commercial banking. Within a few years of its foundation, it was able to establish a number of branches, particularly in the *tarai* region, and today it has fifty offices all over the country.

It was only in 1956 that the country's first central bank, the Nepal Rastra Bank, was founded. Generally, it is under the aegis of the Central Bank that the commercial banks of any country function, and the Central Bank supervises and directs all banking activities. The basic monetary policy is also guided by the techniques employed by the Central Bank which from time to time seeks to regulate the cost of credit, the quantity of credit and the purpose or use of credit. However, because in Nepal

the commercial bank came to be established much earlier than a central bank, the Nepal Bank Ltd. in its early years naturally had to fall back upon itself to maintain liquidity and to keep sufficiently large cash reserves. In essence, it had to act as its own central bank, and keep enough resources on hand for meeting emergencies. Of course, it can be pointed out that, although the Nepal Rastra Bank was set up in 1956, it has only been during the last two years that it has started to give protection and supervision to national banking and financial activities, following the establishment of a number of other financial and development institutions. The Nepal Industrial Development Corporation was established in 1957 to help the private sector in the field of industry. The Co-operative Bank was established in 1963, and the Rastriya Banijya Bank – a state-owned commercial bank – in 1966. The Land Reform Savings Corporation was established in 1966. The Co-operative Bank was converted into the Agriculture Development Bank in 1967 to be the main financing institution for small rural agro-industries and cooperative sectors.

MAIN FUNCTIONS OF THE NEPAL RASTRA BANK

While inaugurating the Rastra Bank on April 26, 1956, King Mahendra expressed the hope that, among other things, the establishment of the Bank might promote the growth of banking, commerce, and industry in the Kingdom and thus rejuvenate the economic life of the country.[9]

The preamble of the Rastra Bank Act, as it was amended on September 25, 1966, lays down the aims of the Bank as being those of 'regulating the issue of paper money, securing country-wide circulation of Nepalese currency and achieving stability in its exchange rate; to mobilise capital for economic development and for stimulating trade and industry and developing the banking system in the country, and thereby insuring facilities and maintaining the economic interests of the general public'. The Bank started functioning with a capital of Rs. 10 million fully subscribed by the Government. Its infancy, of course, has not been without a number of initial troubles. The important func-

[9] Nepal Rastra Bank, *Annual Report of the Board of Directors*, Kathmandu, July 15, 1957, p. 2.

tions of the Rastra Bank include the following: to issue currency notes; to undertake the banking transactions of the Government; to mobilise savings and capital and manage the public debt; to act as the controller of foreign exchange; to promote the expansion of the banking system and control over the functions of commercial banking; to control credit and frame rules regarding banking management and credit control; to act as the Government's banker, agent and financial adviser, and to provide credit to industries in private, government and semi-government sectors, though indirectly, after duly considering the monetary system.

The Rastra Bank was given the control and management of note issue from the very beginning, while the coinage and mint has still continued to be the responsibility of the Ministry of Finance. Currency notes were issued by the Government for the first time in 1945. As will be shown in Table 7:1, there has been a great expansion of the note issue liability over the years. This steady expansion, though partly attributed to inflationary trends, also reflects the replacement by Nepalese rupees of Indian rupees as a result of the expansion of Nepalese currency area over the various parts of the country where hitherto either Indian currency was predominantly in circulation or which were outside the monetised sector.

Another function of the Bank relates to the transaction of Government business. The Act stipulates that, in such conditions as may be agreed upon between His Majesty's Government and the Bank, the entire receipts of the Government shall be deposited free of interest with the Bank, and the Bank shall, as instructed by the Government, do banking transactions such as making disbursements and remittances, and undertaking foreign exchange operations to the amount standing to the credit of the Government. This is, obviously, the traditional function of a Central Bank and need not be emphasised in the present study here.

One of the more important functions is sole monopoly in the transaction of foreign exchange. The Bank has the sole right to deal in foreign exchange at rates fixed by the Government after taking the opinion of the Bank. Until recently there was of course no system of foreign exchange control, and it is only after 1960[10]

[10] A treaty of Trade and Commerce was signed between Nepal and India in September 1960. Accordingly, from November 1960, all the foreign exchange earned by Nepalese exports has been under the Foreign Exchange

that there has been separation of the foreign exchange account, and the administration of this account was entrusted to the Rastra Bank. On October 17, 1960, an Act to regulate transactions of foreign exchange was enforced in the Kathmandu Valley. The Act, by providing for the creation of authorised dealers in foreign exchange and for control of their transactions, has equipped the Bank with an important weapon for bringing about the ultimate use of a single currency throughout the country. Although it does not provide as yet for the surrender of foreign exchange, particularly Indian rupees in individual possession, further measures to bring about the complete exclusion of the Indian rupees from use for normal transactions in the whole country have gradually been taken. In the beginning, the Rastra Bank started foreign exchange transactions by quoting exchange rates for US dollars, sterling and the Swiss franc in terms of Indian rupees. From May 14, 1960, however, the Bank started quoting the exchange rates of these currencies directly in Nepalese rupees, using for this purpose the exchange rates between the Indian and Nepalese rupees, officially fixed by His Majesty's Government. This has eliminated a free market in foreign currencies, including Indian rupees, and today exchange control has been extended to all the parts of the country.

Although, till very recently, the Bank did not have any control over commercial banking, particularly the Nepal Bank Limited, the only commercial bank, the Commercial Bank Act enacted in 1963 and its subsequent amendments have provided the Rastra Bank with wide powers for control and supervision of commercial banks. After the setting up of a state-owned commercial bank, Rastriya Banijya Bank, in 1966, the Rastra Bank has been trying to co-ordinate and control commercial banking activities more effectively. A commercial bank now has to obtain a license from the Rastra Bank for carrying on or commencing banking business in the country. The main object of this requirement is to ensure the growth and stability of banks operating along sound lines, and so discourage the indiscriminate establishment of banks. It also exercises control over the expansion of the commercial banks, for opening new branches or changing the

Laws and Rules of Nepal, and the entire export earnings are being collected by the Nepal Rastra Bank and kept separately for all practical purposes.

TABLE 7 : 1

ASSETS AND LIABILITIES OF THE NEPAL RASTRA BANK

(In Millions of Rupees)

	Mid-July										
	1959	1960	1961	1962	1963	1964	1965	1966	1967	1968	1969 (April)
Assets											
Foreign assets*	96.1	137.9	185.4	215.3	240.2	361.8	429.4	356.5	375.4	592.6	700.6
Claims on Government	11.1	9.7	18.7	37.1	42.0	29.6	32.8	32.9	33.8	30.0	80.6
Advances	—	—	—	13.8†	15.5	0.1	3.0	3.7	5.1	1.9	50.1
Treasury coins holdings	11.1	9.7	18.7	23.3	26.5	29.5	29.8	29.2	28.7	28.1	30.5
Claims on Government Entities‡	—	—	—	—	—	2.0	14.3	24.7	24.2	27.3	30.2
Claims on Banks	—	—	—	—	—	—	3.0	29.4	3.2	10.4	4.8
Claims on Private Sector	0.1	0.1	0.5	0.2	2.9	1.3	3.6	6.2	3.3	3.6	8.0
Other§	25.9	27.2	30.5	38.9	32.3	27.9	30.9	132.5	143.6	75.0	114.0
Liabilities											
Notes in Circulation	46.6	67.6	107.8	124.8	140.5	221.2	276.5	325.4	346.9	403.5	499.5
Deposits	73.1	91.4	104.4	142.4	147.7	168.2	192.0	190.8	165.2	203.1	309.9
Government	67.0	61.5	70.6	86.5	95.2	98.6	117.7	99.8	74.3	146.8	188.6
Banks	2.1	10.9	15.4	11.6	10.8	12.1	10.7	5.3	14.1	31.8	25.4
Other	4.0	19.0	18.4	44.3	41.7	57.5	63.6	85.7	76.8	84.5	95.9
Capital and other Liabilities‖	13.5	15.9	22.9	24.3	29.2	33.2	45.5	66.0	71.4	71.9	128.8
Total Assets = Liabilities	133.2	174.9	235.1	291.5	317.4	422.6	514.0	582.2	583.5	738.5	938.2

* Clearing Account Balance adjusted since August 1962. Indian Currency held in the Banking Department was valued at Rs. 1.30 per Indian rupee up to 1958 and at Rs. 1.50 per Indian rupee in 1959, whereas Indian Currency held in the Issue Department amounting to Rs. 10,000 thousands was valued at Rs. 1.00 per Indian rupee up to 1959. From Mid-July 1960 to June 5, 1966, all the Indian Currency assets have been revalued at Rs. 1.5975 per Indian rupee, and other foreign currencies were also similarly revalued at cross rates. On June 6, 1966 consequent upon the revaluation of the Nepalese rupee vis-à-vis the Indian rupee, Indian Currency assets and liabilities were revalued at Rs. 1.0125 per Indian rupee. The revaluation loss of the Rastra Bank amounted to Rs. 86 million. Consideration will have to be given to the devaluation of pound sterling on November 18, 1967, and the devaluation of the Nepalese Rupee on December 8, 1967.

† Of which NRs. 6.8 million represented a non-interest bearing bond sold to the Nepal Rastra Bank to open the Government IBRD account, which was brought back in October 1962.

‡ Government owned Corporations and enterprises.

§ Includes silver demonetized British-India silver coins. Since April 1966 also include Rs. 14,286 thousands, representing a non-interest bearing bond sold to the Rastra Bank to open currency portion of the IMF accounts, and since mid-January 1968 the amount is Rs. 1,013 thousands only.

|| Rs. 6,789 thousands represented a non-interest bearing bond sold to the Rastra Bank to open the IBRD account of the Government, which was redeemed after mid-Oct. 1962. Since mid-April 1966, also include Rs. 14,286 thousands, representing a non-interest bearing bond sold to the Rastra Bank to open the IMF account of the Government, and since mid-January 1968 the amount is Rs. 1,013 thousand only.

Source: Department of Research and Statistics, Nepal Rastra Bank.

location of the existing ones. Among other powers, the most important is that of inspection of banks, which has the object of helping them develop sound banking traditions by inviting their attention to defects in their existing working.

Another function of the Bank relates to regulating the monetary system of the country so as to promote the maintenance of economic stability and assist the growth of the economy within the framework of the general economic policy of the Government. However, because of the existence of a large non-monetized sector and of an unorganised credit sector even within the monetized sector, the process of domestic mobilisation of savings in the private sector has obviously been fraught with various difficulties. Even the issuing of treasury bills as seasonal ways and means advances to the Government was started only after 1960 and in late 1963 for the first time Government development loans were floated for mobilising private savings, of which nearly 60 per cent were subscribed by private individuals. Of course, the total amount of treasury bills and Government bonds that the Bank can hold is not ordinarily limited. Still, the amount that the Government can discount each year is limited by the appropriations in its approved budget.

FINANCIAL ACTIVITIES OF THE RASTRA BANK

At this point an analytical glance over the assets and liabilities of the Bank will be relevant to give some idea of recent trends; it would also help to show the extent to which the Rastra Bank, as a central bank in an emerging economy, has been contributing both to financial and economic development.

One of the functions of the Bank is that it has the task of mobilising capital for trade and industry and thereby helping in general to mobilise internal resources for developmental activities. It receives private deposits both from banks and others which have, as Table 7:1 shows, increased from Rs. 6.1 million in mid-July 1959 to Rs. 121.3 million in mid-April 1969 (estimates) respectively. It is a fact that, like any other central bank, the Bank does not (and legally cannot) pay interest on the deposits, and its advances to the private sector have been quite small. Still, these increased from Rs. 0.1 million in mid-July 1959 to Rs. 8.0 million by mid-April 1969. This considerable increase

in advances has proceeded quite consistently, and is bound to go up still further. Development bonds were first issued by the Government during the fiscal year 1963/64, to the tune of Rs. 13 million. The Bank has been helpful in the subsequent years in the administration of the loan operation of the Government, and the purchase at the end of the year of all the loans floated. True, one of the important factors which limits the extent of the operations of the Rastra Bank is the lack of the more sophisticated elements of the financial world which are found in the developed countries. At the same time, the note issue liability of the Bank (as shown in the above table), including notes held by the banking system, increased from Rs. 46.6 million in mid-July 1959 to Rs. 346 million in mid-July 1967. The increase was especially marked between mid-July 1963 and mid-July 1964, when it increased from Rs. 140.5 million to Rs. 221.2 million, and even afterwards this trend has continued unabated. In mid-July 1968, compared to the previous year, notes in circulation went up from Rs. 346.9 million to Rs. 403.5 million. This steady expansion, though partly attributable to inflationary trends, also reflects the replacement by Nepalese rupees of Indian rupees.

MONETARY EXPANSION

If, even in a process of economic development in a country there is a sharp monetary expansion over a period, the entire development is eaten up by the price spiral, and the result is that the economy becomes more or less stagnant. Therefore, in any country it is within the purview of the Central Bank's functions that it should adopt a monetary policy within its province so as to achieve equilibrium between demand for and supply of money for achieving the objective of growth with stability. Even if the control of money supply was in the hands of the Rastra Bank right from the beginning, in the past seven years the country has witnessed a sharp monetary expansion, and will be facing further rapid expansion if concerted efforts both by fiscal and monetary authorities are not taken on a co-ordinated basis to control it. While presenting the budget to the *Rastriya Panchayat* for the fiscal year 1968/69, the Finance Minister said: "During the next year we shall seek to co-ordinate fiscal and monetary tools in order that money supply does not expand beyond 15 per

cent."[11] Strictly from the technical angle, other things being equal, the money supply even in the development context should not normally expand by more than 5 per cent per annum. This is the opinion of a number of international experts. But in Nepal, on the basis of past experiences and in the context of the gradually expanding nature of the monetized sector over very recent years, this target fixed by the Finance Minister is not discouraging. For example, in one particular year, 1964, monetary expansion of more than 38 per cent took place. To increase investment, there should be an extension of credit. Needless to emphasise, the recent experiences of a number of developing countries have shown that an integrated approach of development rather than a lopsided growth in one or a few sectors is imperative.

The figures given in Table 7:2 reveal that, particularly after 1960, Nepal's expansion even compared to that of some other developing countries of the world, has been quite sharp. Obviously, a few factors have contributed greatly to the rapidity of money supply. First, over the years there has been a substantial increase in the country's foreign assets, and those assets could not have been adequately utilised for the country's development process. It is remarkable that, during the past three years, the net increase in foreign exchange held (even excluding Indian rupees), after meeting annual foreign exchange expenditure, will have totalled more than Rs. 200 million. This is quite substantial in view of the fact that, even a few years ago, say in the fiscal year 1963/64, the annual earnings of foreign exchange did not normally exceed Rs. 80 million, and that the value of the country's annual imports generally amounted to Rs. 600 million. The current reserve is at least equal in value to nine months' imports. Another element of rising significance has been the steady increase in bank credit to the private sector. At the same time, a third significant expansionary factor, which came into operation after 1963, was the extension by the Rastra Bank of credits to the Nepal Industrial Development Corporation and other Government-owned enterprises.

[11] Ministry of Finance, *The Budget Speech,* Kathmandu, 1968/69, p. 3.

TABLE 7 : 2

MONEY SUPPLY

(In Millions of Rupees)

	1960	1961	1962	1963	1964	1965	1966	1967	1968	1969 (March)
Money Supply (I+II)	174.1	205.4	244.2	264.8	365.7	446.3	507.3	554.1	617.8	695.1
Additional increase over the previous year	—	+31.3	+38.8	+20.6	+100.9	+80.6	+61.0	+46.8	+63.7	+77.3
Percentage increase over the previous year	—	+18.0	+18.9	+8.4	+38.1	+22.0	+13.7	+9.2	+11.4	+12.5
I. Currency in active circulation	109.4	142.0	156.2	161.7	235.3	296.2	345.8	368.6	419.1	485.9
Additional increase over the previous year	—	+32.6	+14.2	+5.5	+73.6	+60.9	+49.6	−22.8	+50.5	+66.8
Percentage increase over the previous year	—	29.8	+10.0	+3.5	+45.5	+25.9	+16.7	+6.6	+13.7	+15.9
II. Deposit Money	64.7	63.4	88.0	103.1	130.4	150.1	161.7	185.5	198.7	209.2
Additional increase over the previous year	—	−1.3	+24.6	+15.1	+27.3	+19.7	+11.4	+24.0	+13.2	+10.5
Percentage increase over the previous year	—	−2.0	+38.8	+17.2	+26.5	+15.1	+7.6	+14.9	+7.1	+5.7

Source: Department of Research and Statistics, Nepal Rastra Bank.

Another still more important factor which has contributed to the expansion of the money supply might be the gradual adoption of the Nepalese currency all over the country over the last few years and the restrictions on the use of Indian rupees for transactions, even maintaining the system of unlimited convertability. To start with, the extension of the money economy at the expense of the subsistence sector requires a stock of money to satisfy the transactions demand for money on the part of those newly entering the monetized sector. Of course, after a certain stage of monetary sophistication has been reached, it will increase at a slower rate. This might, obviously, be one of the factors of the monetary expansion. Another factor has been increased demand deposits of the banks.

By any standards, during the period under review the increase in money supply, as shown in Table 7:2 has been something more than six times. This is a very substantial increase, even if allowances are made for currency unification policy and development activities. The rate of monetary expansion is inextricably connected with the price trends, but the available price data for the country are not reliable and even the indices of retail prices of food and some other commodities are unweighted. Still, as the following table shows, the general price level has been rising quite sharply in recent years.

TABLE 7 : 3

REGIONAL PRICE MOVEMENTS

(Base: Fiscal Year 1961/62 = 100)

Regions	*Averages*						
	1	2	3	4	5	6	7
	1962/63	1963/64	1964/65	1965/66	1966/67	1967/68	1968/69 (III Quarter)
Kathmandu	102.47	112.32	132.56	141.97	122.55	138.33	156.53
Hills	108.14	118.65	132.82	154.55	116.25	131.42	130.76
Tarai	108.55	118.25	132.83	137.75	116.57	155.57	155.93
Nepal	106.38	116.40	132.74	144.87	118.45	141.77	147.75

Source: Department of Research & Statistics, Nepal Rastra Bank.

With the increase in the national income, the desire for liquid assets and the demand for liquidity also considerably increased. Hence, to counteract serious inflationary pressures, which would subsequently have grave repercussions on the country's fiscal, domestic price and balance of payments position, and materially slow down the rate of economic development in real terms, appropriate measures both in monetary and fiscal fields have to be taken to prevent any rapid monetary expansion in future.[12]

CREDIT POLICY

One of the main fields of monetary policy is the control of the supplies of credit and its proper diversion into desired channels, in harmony with the priorities fixed in the planned investment programme. This becomes an ever more challenging responsibility for monetary authorities. That is why, from time to time, the Central Bank with prudence and foresight should take appropriate steps to control the monetary and economic situation of the country. Credit control policy has generally been of two types: the selective credit control like controlling and limiting credit facilities for stock exchanges, inventory stocking, consumers, credit and so on, and direct credit rationing. The selective credit method was very widely used in the post-war years in developed countries, and in recent times even developing countries like India are increasingly taking resort to this device.

There is another method of credit control in which the Central Bank, not being satisfied with mainly seeking to influence the money market through limiting the total quantity of money available in the market, seeks to fix the margin requirements for stock market loans, and so to regulate the flow of credit in that direction. This was first started in the United States, where the Banking Acts of 1933 and 1935 contained such provisions. In India it was in 1948 that the Banking Companies Ordinance authorised the Reserve Bank to issue directives to banking companies in regard to their lending policies in general and any individual transaction.

Irrespective of the various methods adopted in different countries to suit their conditions, an important objective of credit policy in recent times in any developing country has been to

[12] This aspect has received fuller discussion in the concluding chapter.

curb inflationary pressure and the rise in the cost of living in the economy in the development context, without affecting the availability of finance for essential needs which are always on the increase. In other words, there should be controlled expansion of credit. Article 22(i) of the Rastra Bank Act stipulates: "All banks shall abide by the directives issued by Bank from time to time on matters relating to banking management, money and credit." Article 23(ii) states: "Other banks operating in the country shall maintain cash reserves with the Bank in accordance with the policy and the rules laid down by the Bank." This means that the Rastra Bank should be in a position to regulate the following: credit by making changes in the bank rate; open market operations; and variations of reserves which commercial banks are required to maintain with it as well as having extensive powers of selective credit control. Without a large monetized sector, in the given conditions, the Bank can affect money supply very little by open market operations, as there are no marketable government securities other than short-term treasury bills and development loans started very recently. Selective credit controls, which seek to regulate the use of credit for certain specific purposes, can only be operated systematically. In this respect, some modest beginning was made on September 17, 1966, when the Rastra Bank fixed the minimum reserve requirements of the commercial banks with the Rastra Bank at 8 per cent of their total deposits. With increasing experience in the field, the instruments of credit control should be adequately improved over the coming years.

Although, as mentioned above, the Rastra Bank Act provides even for selective credit control, "unless the different parts of the mechanism of credit are properly integrated, each influencing the others according to its position and importance, quantitative control of bank credit may prove inadequate to maintain the economic system on an even keel."[13] The conditions in Nepal are today far from congenial to the wide use of this type of weapon. The Rastra Bank, even with regard to the total requirements of credit or how much the supply of credit should be increased or decreased in the virtual absence of any reliable indicators, can utilise rule of thumb for many years until gradually better conditions are created in the monetary field. In our conditions, it is

[13] S. N. Sen, *Central Banking in Underdeveloped Money Markets*, Bookland, Calcutta, 1967, p. 171.

not only possible, but it is also important, that, other things being equal, direct physical controls over commodity markets should be brought in gradually, with due caution of course, to make the general control policy a success.

INTEREST RATE POLICY

One of the functions of the Central Bank, as enumerated above, relates to control of interest rates of the banking institutions. The present interest rate structure in Nepal has many peculiar features. First, there exists a vast disparity between long and short rates, and also between different sectors and industries in relation to any one type of rate. We cannot regard any interest rate as existing on an integrated basis for all practical purposes. It is generally suggested that, in a developing country, with the many vicissitudes that occur from time to time in its growth process, there should be, ideally speaking, a flexible interest rate policy. But, under the present conditions in which we do not even have banking facilities spread over different parts of the country, particularly in the hilly regions, a number of pre-conditions will have to be created in the beginning. The effectiveness of any flexible interest rate policy depends on a number of conditions such as a developed money market, a high stage of development of the capital market, a rationalised and highly sensitive assets structure of the banks, and above all willing and active co-operation between banks and the central bank. In Nepal, these conditions are either non-existent, or some of them are only slowly evolving in recent years.

A short review of activities in this field will not be out of place here. It was in 1937, after the establishment of the Nepal Bank, that deposits and loans were started out of savings in the banking sector. In those days, in the absence of the Central Bank, the Nepal Bank, on its own, used to fix the rate of interest, and for this there was no legislative control. At first, after the Rastra Bank started functioning as the Central Bank, it had no legislative authority to give directives on matters of banking management, money, credit or even the interest rate policy. It was the Rastra Bank Act (Third) Amendment in September 1962, and its (Fifth) Amendment in September 1966, and also the Commercial Bank Act 1964, that gave the legal authority to the Rastra Bank for

giving directions and framing rules regarding banking management and credit control. In 1966 another state-owned commercial bank, Rastriya Banijya Bank, came into existence. It was thus after 1966 that to have a proper co-ordination between the two banks by way of eliminating unnecessary competition that the Rastra Bank came forward to regulate the interest rate. In a country where (in the rural area) interest rates of 20 to 25 per cent and (in the urban area) 3 to 4 per cent exist side by side, there was naturally a tendency for savings not to flow into the banking sector. Similarly, interest rate in the Indian banks on the other side of the border used to be 4 per cent on savings deposits, whereas the Nepalese banks would pay only 2 to 3 per cent. In one particular year the Indian banks were paying 6 per cent on deposits, while the Nepalese banks paid only 3.5 per cent. Therefore, it had become imperative that the Nepalese deposit rates should be fixed in conformity with Indian rates. For the first time with effect from August 31, 1966, after consulting the commercial banks, the Rastra Bank gave directions to the banks to pay on savings deposits a minimum interest rate of 4 per cent on fixed deposits for one year and more than one year up to seven years 6 to 7 per cent per annum progressively depending on length of deposit. With regard to advances, on the basis of the margin of profits subject to the approval of the Rastra Bank, the commercial banks could fix up appropriate rates from time to time.

The above short review of the operations is indicative of the lower stage of the development in the field. Obviously, under the circumstances, a great leeway has to be made up which can be attained only by experience and by better co-ordination among the various institutions concerned.

DEVELOPMENT ROLE OF THE RASTRA BANK

Apart from traditional role, the development role of the Rastra Bank as the central bank of the country, in the fields of monetary and credit control, have become increasingly important in recent years in the overall context of planning. Recently, the Bank has undoubtedly been playing a significant part in this direction. For example, under the Government's guarantee, the Bank provided a loan of Rs. 2.75 million during the fiscal years 1962/63 and

1964/65 to the Nepal Industrial Development Corporation, and agreed to provide overdraft facilities not exceeding Rs. 26.7 million to the two industries in the public sector during December 1964 and January 1965.[14] Still it has to become increasingly a dynamic leader of the banking system and not remain only its controller.

Since the capital market in Nepal, in the technical sense of the term, has yet to get started on proper lines, it is time, in the present initial stages, that the Rastra Bank should give greater help to financial institutions like the Nepal Industrial Development Corporation, which have, of course, to take a promotional interest in the establishment of new industrial projects. Commercial banks must adhere primarily to short-term lending for the working capital requirements of industry; and the interests of the commercial banks and other financial institutions would be best served by their collaborating with each other to the maximum extent possible. Here the Rastra Bank can play a very valuable role in promoting a good relationship between two classes of institutions. In the situation and needs created by our planned economic development, there should in fact be considerable understanding and full cooperation between the commercial banks, other similar financial institutions, and the Rastra Bank and the Government, and among the financial institutions themselves.[15]

There is thus greater need for more comprehensive and systematic planning for the development of the financial structure needed for the economic development of the country, according to the pace and pattern set for it. It should be admitted that the lack of proper education and general poverty of the masses of the people make the money market approach very inadequate for securing a broad-based national effort for economic growth. Some initial steps are being taken to form a stock exchange market also in the country. But this needs to be supplemented by other approaches, that of public sector enterprises, of special institutional arrangement for financing industry, of a more dynamic and

[14] Nepal Rastra Bank, *Annual Report of the Board of Directors*, Kathmandu, pp. 27-28.

[15] These aspects have been discussed further, on the basis of Nepal's experiences, at appropriate places, in the following chapters.

developmental role of commercial banks under the general supervision and technical guidance of the Central Bank.

Until recently, as the above discussion makes clear, the Rastra Bank has been pre-occupied with the expansion of branches all over the country, almost at the neglect of other functions of central banking. Today, it has five branches—in Kathmandu, Biratnagar, Birganj, Bhairahawa, and Nepalganj; three sub-branches, ten sub-offices and two exchange depots. However, after the establishment of the State Commercial Bank more or less as its subsidiary, the Rastra Bank will be able to devote greater attention to important aspects of economic and fiscal development. Excepting a few branches in important places, the Rastra Bank has been gradually handing its branches over to the Rastriya Banijya Bank. This is obviously a step in the right direction. Since, as a Central Bank, it has to provide a most necessary and specialised public service, rather than profitability being one of its primary objectives, it should not compete with the commercial banks by seeking to attract customers or undertaking other commercial functions, nor should it lend its funds to the public or industrial concerns directly. A few exceptions have been made recently where it has lent directly to the two public sector industries, but such activities should in all cases be discouraged in future. During the coming years, it is necessary that the Bank should gradually be able to make a significant contribution to the development of the market for Government securities by making orderly conditions for dealings therein, and by judicious handling of borrowing and refunding operations of the Government, should thereby foster the growth of financial institutions.

True, in the context of the shortage of capital and the absence of active security markets, it might be argued that the Central Bank should provide even ordinary banking facilities to the country, and that this would enable it to control the money market directly by manipulating its deposit rates and varying its share in the volume of bank credit. Still, the idea behind the commercial banking function of the central bank should not be to compete and earn profit but to direct and control the money market. What, in this respect, needs to be emphasized is that underdeveloped countries must not look for any common formula of central banking operations, and they should try to develop their own system, based on their own traditions and specific con-

ditions. As Prof. Sayers remarked long ago: "If progress is to be real, it must be based on a thorough understanding of the problems rather than on a slavish imitation of what has been done in the countries whose financial institutions happened to develop first."[16]

In fact, monetary policy in the last century has become wider in scope and has changed its aims and methods. Such changes "are quite visible in the shift from the central banks acting only or predominantly as the lender of last resort to a concern with the liquidity position of the entire economy and the stability of the price level.[17] This approach is being increasingly realised in the policy level of His Majesty's Government of Nepal, and recent amendments in the Rastra Bank Act are fundamentally oriented towards this conception.

[16] R. S. Sayers, *Modern Banking*, Oxford, 1960, p. 268.

[17] Raymond Goldsmith, 'The Influence of Financial Structure and Monetary Policy on Economic Growth in Developing States', in *Rehovoth Conference on Fiscal and Monetary Problems*, Jerusalem, August 1965, p. 6.

8

MODERN BANKING

In the preceding chapter it was emphasised, though generally, that the role of banking in the field of economic development is being increasingly realized in modern times in developing countries. The role of the financial system in the process of growth becomes all the more important in the sense that financial institutions as financial intermediaries have to collect the diffused savings scattered in different parts of the country. Obviously, in any country, personal or household surpluses form the main source of genuine savings of the community, and the savers are large in number and widely scattered. Such intermediaries can broadly be grouped under two heads – those falling within the money market and those falling within the capital market. The money market, of which the commercial banks including the Central Bank constitute a major segment, mobilises the savings of the community on a short-term basis, while the institutions of the capital market get command over the resources on a long-term basis. More precisely, "the money market provides facilities for the quick and dependable transfer of short-term debt instruments used to finance the needs of business, government, agriculture and consumers."[1] A money market, whether organized or unorganized, enables individuals and institutions with surplus funds to lend money to others to finance their expenditures. In the present chapter, based on Nepal's recent experiences, some analysis has been attempted with regard to the functioning of the commercial banks, more particularly the working of the two commercial banks so far evolved in the economy.

[1] Herbert E. Dougall, *Capital Market and Institutions,* Prentice Hall, London, 1965, p. 4.

BANKING SYSTEM AND ECONOMIC DEVELOPMENT

It needs to be emphasised that the extent of reliance on the banking system for meeting the requirements of development has differed from country to country. For example, in the United Kingdom during the period of its industrial development, bank credit was used chiefly for working capital purposes, while the medium-term or long-term capital was supplied from earnings. However, even in the nineteenth century, in the countries of the continent like France and Germany, banking was more closely associated with the process of development. Banks were also interested in direct industrial finance. For example, "during the period of German industrialisation, the extensive renewal of short term loans by German bankers subject to safeguards, meant in effect that they financed long-term investment and became controlling partners in many industrial firms."[2]

Banking, as already mentioned, is of recent development in Nepal, although the record of modern banking, even in a few years, has not been unimpressive. The pioneer contribution of the Nepal Bank since 1937 has been quite significant. However, in relation to the magnitude of the tasks involved, the lee-way that remains to be made up is still very large. The credit needs of the people are still predominantly met by indigenous money-lenders, and a very large portion of the productive activity of the community still remains completely outside the purview of the organised banking system.

In Nepal, such indigenous bankers have flourished from very early times. Towards the close of the fourteenth century, a number of reforms were initiated, and from then on money-changing as a profession started to be pursued by a section of the people in the Kathmandu Valley. On the eve of the Gorkha conquest, the home trade of Nepal was brisk. Some trading activities were undertaken through the foreign merchants, the bulk of the Nepalese trade being concentrated in their hands. Although there were no banks of the modern types, some indigenous bankers conducted banking activities individually along with other occupations, and this trend for Nepalese nationals to take on money-lending activities became more dominant in the last quarter of

[2] B. K. Madan, *Aspects of Economic Development and Policy*, Allied, Bombay, 1964, p. 216.

the last century. Even up to the setting up of the Nepal Bank in 1937, there were indigenous bankers carrying on some semblance of commercial banking in the orthodox sense.

THE NEPAL BANK

In the midst of the above unrelated and quite unco-ordinated conditions, the Nepal Bank Ltd. (the first commercial bank) was established in 1937 on government initiative. Right from the very beginning it has been a semi-private and semi-government organisation (the Government having the ownership of 51 per cent of the paid-up capital). The Bank had to pass through a number of vicissitudes during its early years. Still, it has done pioneering work in taking the banking habit to the people, who were generally used to the traditional practices of monetary transactions in the non-monetized sector. Since the Nepal Rastra Bank was founded only as late as 1956, for a few years the Nepal Bank had to manage, apart from commercial functions, almost all banking transactions including those of the Government, however limited. The entire business of note exchange and related activities was also entrusted by the Government to this Bank. Up to 1965, before the establishment of the Rastriya Banijya Bank, this bank was an authorised agent of the Rastra Bank. In places where the Rastriya Banijya Bank does not have branches even today, it undertakes a number of activities including the foreign exchange buying and selling business. The Nepal Bank has today fifty branches in various parts of the country, particularly in the *tarai* region. In quite recent years, branches in the hilly areas of the country have been established, in line with the gradual completion of roads to these parts. Coverage is not adequate, however, in the interior parts of the hilly regions. It has agencies in India, United States, Britain, Switzerland and West Germany.

The Bank started with a working capital of less than Rs. 10 million, although it was decided to subscribe Rs. 25 million as share capital. In those early years, the main functions of the Bank were government exchange business and the advancing of money to the public against gold and silver, till then handled by a Government department. Gradually, its transactions widen-

ed with expanding banking and commercial activities. The beginning of the Second World War badly affected its business. In 1944, the functions of the Bank, other than note exchange and the granting of advances against gold and silver, were virtually at a standstill. The commodities for trade could not be imported even from India, with a result that the exchange rate for Indian currency against Nepalese currency fell to 100/60. The Government came to the rescue of the Bank, and it was given the monopoly of cloth import business under quota allotted by the Government of India, with the necessary capital at a nominal rate of interest. This resulted in an increase in profits with proportional development of business.

The Nepal Bank was set up at a time when banking was little known in the country, all banking activities being limited to money lending. As mentioned above, it was as late as 1956 that the first Central Bank was founded. So long as commercial banking remains in private hands, the Government should be content to leave its detailed administration to the commercial banks themselves. Still the Government has a clear duty to ensure that the distribution of bank credit – i.e. physical resources in the economy – is broadly in consistent with the basic pattern of development. This has been, in general, the experience of a number of countries in Asia and Africa. Hence, the Central Bank needs powers to ensure that, as far as possible, consistent with the development schemes, important sectors of the economy are given proportions of the available financial resources. In the context of changed banking habits and the overall presence of the Central Bank after 1956, suitable amendments in the banking legislation became almost over-due. At the same time, for the overall projection of Government banking and monetary policy, some technical control by the Central Bank is always quite necessary. The commercial bank's capacity to operate effectively also depends on its being able to provide the best possible banking facilities for its customers, and in the long run the provision of facilities for deposits in foreign currencies would probably turn out to be in the best financial interests of the country. In consideration of all these aspects, His Majesty's Government got a commercial banking legislation enacted on March 29, 1964, and the Nepal Bank Act of 1937 was annulled. Under the new Act any commercial bank including the Nepal Bank could function either

entirely in the private sector or in collaboration with the public sector.

COMMERCIAL BANKING LEGISLATION

It seems relevant to refer to some of the important clauses of this Act, which marks a clear step forward in banking development. Under the old Act, although the Government owned (and still does even now) 51 per cent of the paid-up capital, it had only 30 per cent of the voting power. Under the new Act, in case the Government had more than 50 per cent of the shares, it could appoint the Chairman and the majority of the directors. Although the Act describes as commercial banks those banks that are engaged in commercial banking transactions, and excludes from this description such banks as are established for achieving certain specific goals such as cooperatives, agricultural and industrial banks, much wider activities in relation to the economic development of the country have been empowered to the banks. Apart from strictly performing commercial functions, commercial banks so described in the Act are empowered to perform such functions as the undertaking of agency business e.g. in the issue of shares and debentures for public corporations; guaranteeing and underwriting foreign exchange business under the restrictions imposed by Foreign Exchange Act rules, orders and notifications; advancing loans for periods not exceeding one year against the security of jewellery, gold and silver ornaments or gold and silver bullion, or against the mortgage of land and buildings, for acquiring plant and machinery; and receiving deposits of Government money according to the order of His Majesty's Government in those places where there are no branches of the Nepal Rastra Bank or the Rastriya Banijya Bank, or where the Rastra Bank gives its consent to remit money through bills of exchange and cheques in Nepal and foreign countries, and so on.

Under the old Nepal Bank Act, the Bank was unable to lend against immovable property, and this factor was militating against the wider use of the Bank's deposits. The result was that the use of credit for risk ventures was severely limited, and it also meant that the Bank had only a narrow outlet for its deposits. Under the new Act this difficulty has been satisfactorily resolved, as it can legally advance loans against the mortgage of land and

buildings. Since the country's main source of wealth exists in its land, it is necessary that it should be possible for land to be pledged as security for loans. This is bound to attract advances from the commercial banks, discourage other forms of money-lending which require to be supported by exorbitant rates of interest, and help in accentuating the pace of the economic development of the country both in the private and public sectors.

The 1964 legislation also strengthens the hand of the Central Bank in matters of auditing, since it is now necessary to have the consent of the Rastra Bank for the appointment of one of the two auditors as provided for in the Act. Depending on its discretion, the Rastra Bank shall be able to inspect any office of any bank. That bank shall be bound to follow all directions and orders of the Rastra Bank, which shall also be the channel of communications between itself and the Government for any sanction and approval sought for under the Act. In underdeveloped countries, it should be possible for the Central Bank, in the context of the over-all need for and greater scarcity of capital, to impose some pledge of broader official control over its allocations than has been the case so far. It should usually be in a position to specify that bank advances to certain sectors should not exceed a particular sum or a given proportion of all bank advances, or expand at more than a specific rate. Such banking regulations providing for the inspection and audit of the banks by the Rastra Bank help to keep a check on unsound banks. Before this the Nepal Bank did not send any continuous or regular supply of information regarding the activities or investments of the commercial banks to the Rastra Bank. Obviously, this is a major improvement.

THE RASTRIYA BANIJYA BANK

The Rastra Bank had until 1965 been pre-occupied with the expansion of its branches over the country, even to the extent that its central banking functions were considerably neglected. However, the establishment of the Rastriya Banijya Bank – a state-owned bank – on July 23, 1966, as its subsidiary under a special Act legislated on April 11, 1965, has enabled the Rastra Bank gradually to devote more attention to important aspects of economic, monetary and fiscal developments. Of course, the purpose of the Bank has also been, as mentioned in the preamble

of the Act, to provide facilities and help towards the economic welfare of the general public. Since the Rastriya Banijya Bank was founded, most branches of the Rastra Bank have gradually been handed over to it, and, both as an agent of the Rastra Bank and as a commercial bank, it has been substantially contributing to the development of the banking system, particularly in the remote areas which are presently not served by a commercial bank. It now has twenty-seven branches, more than half being located in the hilly regions.

With the gradual expansion of commercial activities and hence of the monetised sector, banking needs in different parts of the country, particularly in the underdeveloped hilly regions, have been rapidly increasing in recent years, and the Nepal Bank proved inadequate to provide all the necessary services. The Rastriya Banijya Bank was therefore set up in the public sector with an authorised capital of Rs. 10 million. Under its special Act, where there is no office of the Rastra Bank or where the Rastra Bank permits, it may hold or pay gold, silver, money or other securities on behalf of the Government, and undertake other banking business, as permitted by the Rastra Bank on behalf of the Government.

WORKING OF MODERN BANKING

During their existence, the Nepal Bank for more than thirty-two years and recently the new Rastriya Banijya Bank have been in a position to extend their activities and show several developments of interest. As shown in the following table 8:1, demand, fixed and savings deposits rose between mid-July 1963 and mid-July 1966 from Rs. 103.7 million to Rs. 182.1 million. Foreign assets, which include foreign currency in hand and balances held in foreign banks, did not however increase – the figures being Rs. 27.4 million and Rs. 26.4 million respectively. During the same period, advances to the private sector and investments increased from Rs. 59.1 million to Rs. 146.5 million, the bulk of which was used to finance trade with India. The rest of the banks' loan consists mostly of advances against the collateral gold and silver bullion, fixed deposit receipts, share certificates and property title deeds. The principal concern of both the banks with import and export trade has given rise to foreign assets in Indian currency

which were nearly a sixth of its total assets as of mid-July 1964. With the wider expansion of the Nepalese currency area over recent years and the absence of the convertability of Nepalese currency against Indian currency, this large volume of assets in Indian rupees posed a serious problem at one time, although after the revaluation of the Nepalese Rupee on June 6, 1966, this is not assuming so much importance.

It should be clear that the creation of a central bank, endowed with the necessary authority, is ultimately a development which is undoubtedly in the interests of the commercial banks themselves. In fact, it is only by working in co-ordination and co-operation with the commercial banks that the central bank can contribute on a large scale to the economic stability and prosperity of the country. It was with the realisation of the need to have a number of commercial banks in the country that the Government repealed the old Act, which only applied to the Nepal Bank, and promulgated a general Commercial Bank Law to govern all the commercial banks. While the Act, as explained above, provides for the over-all technical guidance of the Rastra Bank, it gives an opportunity for potential 'indigenous bankers' to establish new commercial banks. Of course, it will be some years before the private sector in its entirety will be interested in the establishment of commercial banks, because the private sector, in the strictly technical sense, has not yet evolved in the country. There are no discount houses or acceptance houses or other types of savings institutions, and in this connection even an insurance company has only recently been set up. In most developing countries commercial banks supply about three-quarters of the short-term loanable funds in the organized money markets, inclusive of loans made by governments. The proportion is still less in Nepal.

In the banking development of a country, competition in the provision of banking services to the general public is in fact very desirable. To this end, recent developments in the country are quite impressive. In growing countries, in this field as in others, it is quite necessary for the Government to take the lead initially and to arouse incentive among the people. By separating off some of the commercial functions from the Rastra Bank, even the existing Nepal Bank will have more fair competition with the new Rastriya Banijya Bank, because of the relationship

TABLE 8 : 1

LIABILITIES AND ASSETS OF THE COMMERCIAL BANKS

(In Millions of Rupees)

	Mid-July	*Mid-July*	*Mid-July*	*Mid-July*	*Mid-July*	*Changes during Mid-July*				
	1963	1964	1965	1966	1967	1963/64	1964/65	1965/66	1966/67	1967/68
Capital and reserves*	5.6	5.9	9.8	12.3	13.0	+0.3	+3.9	+2.5	+0.7	–
Deposits	103.7	117.9	136.1	136.1	182.1	+14.2	+18.2	–	45.6	+40.8
Current	(61.4)	(72.9)	(86.4)	(75.8)	(181.7)	(+11.5)	(+13.5)	(−10.6)	(+32.9)	(+5.4)
Fixed	(32.6)	(31.9)	(32.4)	(34.0)	(44.5)	(−0.7)	(+0.5)	(+1.6)	(+10.5)	(+29.0)
Savings	(6.7)	(7.6)	(10.9)	(15.2)	(19.2)	(+0.9)	(+3.3)	(+4.3)	(+4.0)	(+6.9)
Others†	(3.0)	(5.5)	(6.4)	(11.1)	(9.3)	(+2.5)	(+0.9)	(+4.7)	(−1.8)	(−0.5)
Borrowing	–	–	3.0	29.4	3.2	–	+3.0	+26.4	−26.2	+6.8
Other Liabilities	7.1	8.3	13.5	19.0	16.6	+1.2	+5.2	+5.5	−2.4	+31.8
Liabilities – Assets	*116.5*	*132.1*	*162.4*	*196.8*	*214.5*	*+15.6*	*+30.3*	*(+34.4)*	*+17.7*	+79.4
Foreign assets‡	27.4	17.6	18.2	4.2§	26.4	−9.8	+0.6	−14.0§	+22.2	+9.7
Cash in hand‖	9.4	12.9	12.1	11.5	13.9	+3.5	−0.8	−0.6	2.8	+2.0
Balance with the Rastra Bank	7.2	5.1	9.2	2.8	11.4	−2.1	+4.1	−6.4	8.6	+12.4
Investment¶	4.7	3.2	3.4	3.5	3.5	−1.5	+0.3	+0.1	–	+1.1
Loans, Overdrafts & discounts	59.1	88.4	106.7	162.4	146.5	+29.3	+18.3	55.7	−15.9	+51.5
Other assets	8.7	5.0	12.8	12.4	12.8	−3.7	+7.8	−0.4	0.4	+2.7

* Includes only general reserves.

† Includes margin and cashiers security deposits.

‡ Includes foreign cash in hand and balances held in foreign banks.

§ On June 6, 1966, the NC/IC exchange rate was changed from Rs. 160.00 to Rs. 101.25 per IRs 100.00. The revaluation loss to the commercial banks amounted to Rs. 4.4 million.

‖ Includes only Nepalese notes and coins.

¶ Includes also investment in private securities amounting to Rs. 160 thousand.

Note: Financial Statement of the Rastriya Banijya Bank, incorporated since mid-July 1966.

Sources: (1) Balance Sheets of the Nepal Bank.

(2) Balance Sheets of the Rastriya Banijya Bank.

between the commercial and central banking functions of the Rastra Bank. In a recent bulletin the Nepal Bank acknowledges quite appropriately, "This new phase has unfolded new avenues of investment to the budding commercial banks, which have to everybody's satisfaction so far picked up the latest fashions and traditions of banking business, which has contributed by and large for the quick development of trade and industry of our country."[3]

Of course, even with the gradual expansion of the monetized sector of the economy, the scope being very limited and there being a lack of proper control in the context of the dual currency, the principal sources of credit are still the indigenous money-lenders and other intermediaries like the big landlords, even after the initiation of land reform in the rural areas of the country. They generally charge high rates of interest and purchase crops from farmers at low prices, the payment for which is offset against the debt obligations. Such conditions, however, are bound to exist in a developing country for many years to come.

However, even in the face of existing limitations, the commercial banks have provided a large amount of funds to industries through the purchase of securities, and have also, of course in a quite modest way, helped industries in raising long-term capital from other sources.

In spite of the measures for improving the situation taken increasingly by the authorities concerned, there is still a long way to go, and a well-conceived banking policy is still lacking in the country. Bank credit has not yet assumed such significant magnitude in Nepal as to require quantitative controls, although in recent years the rate of expansion, although gradual, has been quite pronounced. The more important problems are related to attracting the savings to the maximum extent possible, to canalizing these savings into sectors of the economy where they are most needed, and to extending the banking facilities to the unbanked areas. The insufficiency of banking facilities in Nepal is reflected by the fact that only about 278,000 persons are served by one commercial banking office. It is quite imperative that a properly conceived scheme of developing the banking system to fit into the country's overall economic planning should be brought

[3] Nepal Bank Limited, *Monthly Bulletin*, Kathmandu, June 1968, p. 5.

into existence. So far the private sector's general inaction has only reinforced the belief that, in a country like Nepal, the Government should itself step in to develop the institutions needed by the country.

THE RASTRA BANK AND COMMERCIAL BANKING

However, under the aegis of the Nepal Rastra Bank, commercial banking in the country will develop substantially in future. There are sufficient recent illustrations to prove that the Rastra Bank is consistently working on these lines. Commercial banks' branches have not yet been opened in most of the interior parts of the country. True, lack of banking facilities in such regions where an adequate volume of business does not exist makes it difficult to develop such regions, and hinders the monetisation process and the provision of remittance facilities. This also creates difficulties in the financial administration of the Government and the implementation of development works. With a view to resolving these difficulties, it has been planned to open by the end of the fiscal year 1969/70 one bank office in each of the thirty-four districts where today banking facilities do not exist at all.

The Rastra Bank has created a banking development fund for the development and expansion of banking facilities. The Rastra Bank over the years has been transferring every year a part of its profits to this fund. The commercial banks have also followed for some years the directives given by the Rastra Bank to transfer certain percentage of their profits in such a fund started by each of them individually. It has been arranged to utilise this fund in order to compensate the commercial banks for the losses incurred by them in the first three years on the basis of mutual understanding between the Rastra Bank and the commercial bank concerned, in opening and running the bank branches in places prescribed by the Rastra Bank and also towards the training of bank employees.

In its ultimate analysis, any systematic development of commercial banking on modern lines is dependent on the extent of closer co-operation between the Central Bank and the commercial banks. It should be through persuasion and other suggestive approaches that the Central Bank, irrespective of its authority given by the law, should normally seek to achieve its ends while

dealing with the commercial banks. As in other developing countries, the commercial banks in Nepal have been reluctant to purchase government securities, and for that reason, after the floatation of the Government development bonds in 1964, the Rastra Bank has guaranteed to purchase them. Thus, legislation has been passed by which commercial banks are required to hold a certain percentage of their deposit liabilities in government securities. However, it is also necessary, in the overall interests of the country, that the Central Bank should go further than the commercial banks and establish contact with other financial institutions in order to exercise effective control over the market as a whole under emergencies. As has been rightly said, "It should also have a side door or emergency exit, or whatever you like to call it, by which it could reach the outside world otherwise than by way of the other banks. No one would like to live in a house with only one exit."[4] Obviously, the Nepal Rastra Bank also, with all its responsibilities, should have this attribute.

It is necessary that the banking system in the country should increasingly respond to the demands of a dynamic society. The advances 'port-folio' of the banking system should be oriented increasingly to the needs of the industry. As Dr. Madan, taking the case of India, suggests, "An extension of the scope of institutional credit facilities requires advances on a double front: a reform of business methods and standards so as to conform increasingly to the minimum requirement of the banking system, in other words making the economic activity in the rural sector 'bankable' e.g. through maintenance of accounts, greater regularity in meeting debt service obligations, etc.; on the other hand, adoption of banking technique and practice so as to take account of the requirements of this large and important sector, vigorous expansion of which on an efficient basis is vital to preservation of the community's democratic life."[5]

The importance and prosperity of banking is peculiarly dependent upon the general level of prosperity of a country, and is of course liable to increase if incomes and output rise steadily and rapidly. Indeed, no institution has a greater or closer

[4] Royal Commission on the Banking and Currency System in Australia, 1937, p. 1205.

[5] B. K. Madan, *Aspects of Economic Development and Policy*, Allied, Bombay, 1964, p. 217.

interest in well-established, expanding and successful industry and agriculture than a commercial bank; anything which contributes to economic development contributes to the growth and prosperity of commercial banking.

Our main problems of development are also problems of mobilisation of resources, of promoting savings and stepping up the rate of capital formation and keeping a check on inflationary pressure that is bound to be generated in the process of growth. Is our banking system acquiring the dynamism needed to serve the requirements of a developing economy facing various problems and challenges? Is the present structure of our banking going to prove adequate and satisfactory for our purposes? As one expert suggests, there are four major factors affecting the efficacy of a bank: the nature of ownership, the geographical location of the institution, its size and its standard of honesty and efficiency in business.[6] Consistent efforts will have to be made to provide relevant answers to such queries. Other things remaining equal, it seems certain that with the Government's continuously increasing emphasis on the country's economic development through periodic plans, and with improvement of the financial institutions through experience in the field and under adequate supervision of the Rastra Bank, commercial banking has a great future in Nepal in the years to come.

In a growing economy, it is necessary for economic growth that, with innumerable investment opportunities, the personal savings should be properly channelled and a large portion should go for productive investment. In Nepal, however, although even a rough estimate has not been made, less than one-fourth of personal savings seems to have been channelled for productive purposes, the remainder going for unproductive purposes. This accounts for the magnitude of the problem connected with the capital market, which is almost non-existent – or we can say that it has only recently started to evolve. In addition to the commercial banks, there are, of course, some other financial institutions or non-bank financial intermediaries, "which should undertake the important job of activising the increasing flow of personal savings so that most of the idle hoards are diverted from unpro-

[6] J. Daniel Khazzoom, *The Currency Ratio in Developing Countries*, Fredrick A. Praeger, New York, 1966, p. 30.

ductive channels to productive uses."[7] In Nepal in very recent years, in addition to commercial banks, such institutions have been slowly growing and trying to collect medium-and long-term savings as deposits and permanent savings as capital, as well as investing in Government securities and share stocks and debentures of the companies now existing in the country. It will be the purpose of the following chapter to analyse their role in the context of the long-term economic growth of the country.

[7] Alak Ghosh, *Financial Intermediaries and Monetary Policy in a Developing Economy*, World Press, Calcutta, 1964, p. 67.

9

FINANCIAL INSTITUTIONS AND LONG-TERM DEVELOPMENT

THE capital market, broadly speaking, comprises institutions such as provident fund, long-term industrial and agricultural banking or financing agencies, life insurance companies, and so on, which seek to get command over the community's resources on a long-term basis. The capital market is the market where the money value of the instrument of ownership and of long-term claims to assets are transferred. Funds raised through debt instruments by business and individuals are invested in fixed assets and inventories. Quite rightly, the proceeds of government bonds and shares of the various corporations are used to finance a variety of expenditures and types of assets. Before any discussion is offered regarding such institutions in Nepal, it seems germane to refer, however briefly, to some of the practices of some countries with regard to providing long-term financing for economic development. As Nepal, like most of the developing countries, suffers from the almost complete lack of a capital market, both the commercial banks and the other non-bank financial institutions consequently have a special role to play in the long process of growth. In principle they should undertake the responsibility for activating the increasing flow of personal savings so that the amounts of hoarded wealth are diverted from unproductive to productive uses.

INSTITUTIONS TO MOBILISE RESOURCES

In all countries of the world, both developed and developing, during the past three decades, there has been an attempt to

increase the supply of the main ingredients for successful industrialisation, such as entrepreneurship, accessibility to modern manufacturing techniques, efficient management, skilled personnel, markets and capital. Accordingly, they have established special institutions to mobilise their resources of capital, and to channel them into productive sectors of the economy. Virtually, all such institutions have been sponsored by governments; some are devoted to the promotion and financing of government enterprises, others exclusively to private investment. At any rate, within basic limitations, these institutions, are generally being adapted to new circumstances with the hope of stimulating economic development.[1]

Until quite recently, it was widely believed that, in a world of perfect territorial division of labour, the function of the agricultural countries would be to produce goods in which their comparative efficiency appeared to be the greatest—that is, goods which were labour-intensive and land-intensive rather than capital-intensive. But it is now felt that agricultural development alone cannot boost the economy, even on a land-based country as a whole, any further without a corresponding rate of industrialisation, however gradual the process might be. Of course, in the initial stages great reliance should not be placed on heavy industries (just as India did during the First and Second Five Year Plans), at the expense of the agricultural sector. Industrialisation, besides leading the country to the path of economic development, also helps the individual entrepreneurs to invest their savings in the most advantageous ways. The productive resources of the country have many alternative uses, and they should be employed where they get the maximum returns. But the primary requirement for the proper development of both industry and agriculture is an adequate and flexible supply of finance; this constitutes the very foundation upon which the superstructure of either modern agricultural or industrial organisation will have to be erected on a proper co-ordination.

The basic conception of finance is capital, and when we talk of capital or capitalisation we consider it broadly from these two points of view: the amount of capital and the composition or form of capital. The amount of capital will depend upon whether

[1] See my article, 'NIDC's Role in Nepal's Development', in *Nepal Industrial Digest*, Kathmandu, September 1966, pp. 19-20.

we adopt the capital-intensive or labour-intensive technique. Inadequate capital, shortage of internal savings, the absence of a pioneering middle class to act as entrepreneurs, and the absence of technical know-how do not permit the country at present to develop such industries which require a high degree of intensity of capital. Under these circumstances, only industries operating on a small-scale basis can have good prospects in most developing countries. Such industries alone, however, cannot promise a high standard of living. This is the vicious circle which all developing countries, trying to achieve a high standard of living, have somehow gradually to break through. The experience of a number of developing countries is replete with this basic strategy. A planned economy will obviously require more capital per year than an economy which is allowed to develop under private enterprise, because under the former prices and costs are not allowed to exert the same influence as under the latter, and because an extensive process has to be condensed into a short process of intensive development.

PROCESS OF CAPITALISATION

Two kinds of capital are required for development: fixed capital and working capital. Fixed capital is required to buy such factors of production which are permanent by their very nature, such as plant and machinery, land and building, furniture and fixtures, etc., whereas working capital is needed to finance the day-to-day transactions such as purchasing raw materials, paying wages, maintenance costs, and the like. What should be the proper proportion of fixed and working capital is purely a technical matter which differs in every case; thus it must be decided before any scheme of industrialisation or the entire process of economic growth is carried out.

Again, the process of capitalisation involves three stages. The creation of savings in the first stage relates to a surplus resulting from an excess of income over expenditure. The sources of savings may comprise individuals, business houses, non-commercial institutions, public authorities and so on. Mobilisation of savings forms the second stage, at which savings are converted into funds which may be available for the private and public sectors for investment in the development activities. Acquisition

of capital goods is the third stage, which is capitalisation in the real sense of the term.

The rate of capitalisation in any country depends basically upon the willingness of the people to invest and the willingness of the economy to absorb the additional funds, which in their turn depend on many factors, such as the level of national income and its distribution, the habits of the people, the structure of taxation, labour conditions and general political and economic conditions in the country.

WORKING OF FINANCIAL INSTITUTIONS

The extent to which dependence has been placed on banking and financial institutions has been different in different countries. In the United Kingdom the work of investment banking is mainly done by Issue Houses. There are also a number of private institutions known as 'Merchant Banks' which are mostly very long-established and have been specialising for a long time in the issue of securities, particularly overseas securities. Originally, they were bankers specialising in the business of acceptance of bills arising out of international trade but gradually, in course of time, they began to deal in long-term loans also, and recommend the conditions about foreign shares. Such activities brought about beneficial results in the sense that people started having confidence in them. In recent years, however, their business of raising funds for foreigners has declined and they have therefore increased short- and long-term financing of domestic industries.

The main function of an issue house is to place new issues of securities before the investors with recommendations. They carefully scrutinise the securities and, if they are satisfied about their soundness, they offer these securities to the investing public. The association and recommendation of any one of these issue houses with a new issue of securities is a strength of respectability and is almost sufficient in itself to induce investors to invest in those securities.

As against the classic British theory of banking, commercial banks in continental European countries, more particularly in Germany, are also interested in industrial finance. Whenever any industrial concern needs capital, it approaches a number of banks simultaneously which, after careful examination of the proposals,

form a consortium and jointly provide the funds needed by the borrower by purchases of shares and debentures. They also appoint their representatives to the supervisory board of the borrowing concerns. They are, however, not interested in management of the concerns. Rather, the general policy has been to sell these shares and debentures to the general public at the earliest possible opportunity. Besides some weaknesses, the system of mixed banking has suited the genius of the German people and been instrumental in accentuating the industrial development of Germany.[2] The system works admirably, and there is unanimity of opinion that it was largely due to the keen interest which banks took in its financing that German industry could grow so rapidly, and that German industrial plant, which had suffered enormous devastation during the Second World War, could recover even beyond its pre-war status within only a few years, at a time when there was extreme scarcity of capital in the country. "The adaptability of the banking system to facilitate, in the best possible way, the post-war (II) reconstruction has been adequately illustrated in Japan also. Bank loans which had supplied about 12 per cent of industrial funds in the pre-war years (1934-1936) constituted as much as 6 per cent of such funds in 1951."[3]

In the USA investment bankers primarily responsible for new issues of securities are known as 'originators.' In most respects they resemble the 'issue houses' in Britain, and like the latter they act in a consultative capacity. A borrower contemplating the issue of securities gets into touch with some leading firm of investment bankers, discusses all the related matters with him and seeks his advice regarding various aspects of the issue. The investment banker carefully examines these proposals, availing himself of all possible information, furnished by the engineer, the accountant, the banker and the successful business leader, and tests it all in the crucible of his experience and training. The security which passes the acid-test of this process may be regarded as possessing the merit to which a reputabe investment banker certifies.

[2] For details, see my book, *A Study in Industrial Location*, New Book, Bombay, 1957, p. 175.

[3] B. K. Madan, *Aspects of Economic Development and Policy*, Allied, Bombay, 1964, p. 216.

But the function of an originator does not end here. He is primarily an underwriter and here he differs from an issue house in Britain which only places new issues of securities before the public with its recommendations. Sometimes an originator also invites others to join him in underwriting, partly because his own resources are limited and partly because he wants to avoid risking a disproportionately large amount of his resources in any one issue. When that is the case, all the underwriters including the originators form a 'purchase group', and they jointly underwrite the issue.

THE PRIVATE SECTOR AND INVESTMENT IN NEPAL

This brief outline of the working of financial institutions is germane to our study, since it helps in understanding and applying some of the experiences arising from our conditions and conventions. In Nepal the private sector has taken more interest in trade and commerce than in industrial ventures—and the landed aristocracy (the propertied class) in the past had always taken an indifferent attitude to the country's economic development. It is therefore natural that industries have not so far developed rapidly in the country. Industrialisation in Nepal was first set afloat just at the onset of the Second World War. Since then a number of industries have been set up but the increase in productivity of manufactured units during the last thirty years has been at least offset by the liquidation and uneconomic operations of a number of industries. Moreover, traditional cottage and village industries of several types have also suffered a decline in recent years because of their inability to compete with the imported products of big industries, in spite of occasional protective tariff policy announcements by the Government.[4] Even if the process of gradual expansion has continued in recent years, they are not well equipped with the right kind of machinery, proper sanitation and the right kind of atmosphere to bring the best out of the workers. Power and water supply also are not adequate.

[4] For example, in the budget speech for the fiscal year 1968/69, the Finance Minister emphasized that one of the objectives of the tax policy was to enable domestic production to stand in fair competition with the imported commodities, vide, Ministry of Finance, *The Budget Speech*, 1968/69, p. 10.

GROWTH OF LONG-TERM FINANCIAL INSTITUTIONS

In the preceding chapter the institutions associated with short-term loans were discussed, and those included the commercial banks with their overall supervision by the Central Bank. While, in the field of monetary policy, these institutions have an important role, we are more concerned here with long-term trends. Although such institutions are gradually growing, particularly after 1958, most of them are still in their infancy. As noted above, in the past three decades, the governments of an increasing number of developing countries have created, or have promoted the organization of development banks, and such institutions have taken different forms in consonance with their own local conditions, traditions and practices. "The Etibank of Turkey, created to exploit mineral resources and to build power plants on behalf of the Government, and the Industrial Credit and Investment Corporation of India, established to provide long-term finance to private industry, are some of the examples."[5] Although the distinction between loan-providing development banks and equity-providing development corporations may perhaps be blurred, it does help to emphasize specifically the two objectives common to virtually all such institutions: the provision of capital and the provision of enterprise when either or both of these requisites of economic growth is thought to be lacking.

WORKING OF THE NIDC

The Nepal Industrial Development Corporation is a public Corporation, set up in 1958, and exclusively owned by His Majesty's Government to encourage and assist private investment in the country. The authorised capital was Rs. 10 million, which was raised to Rs. 30 million in the fiscal year 1963/64. It has so far been the single agency to promote and finance medium and big enterprises in the private sector. Its development in recent years has been quite spectacular, even in the context of a number of constraints facing the country in the process of development. As an industrial finance corporation, the institution performs the following main functions and services:

[5] William Diamond, *Development Banks*, Johns Hopkins, Baltimore, 1957, p. 1.

participation in the development of private industrial enterprises; extension of medium- and long-term credit facilities for industrial concerns; furnishing financial advice to the government and to private entrepreneurs; assistance in the creation, expansion and modernization of private industries; sponsoring, underwriting and selling new issues of shares and securities and generating loans raised by industrial concerns through commercial banking facilities in the country. Loans are generally granted for a period of up to fifteen years, depending upon the nature of the project. Interest and amortization of the principal amount is payable in six-monthly instalments. The Corporation may finance an enterprise up to a maximum of 65 per cent of the total value of its fixed assets.

Basically, the Corporation has provided finances to a number of indigenous industries such as jute, biscuit and confectionery, pharmaceutical, sugar, rice, flour and oil, marble, textile, fertilizer mixing, cattle feed, straw-board, furniture, manufacture of matches, aluminium utensils, transport and hotel projects and so on. It has also undertaken a number of feasibility studies. These include paper, plywood, chipboard, straw-board, tea, brewery, woollen goods, tannery, bone mill, cold storage, powerloom, jute twine and rope, soap, vegetable oil and hosiery industries. In more recent years it has been conducting a number of training courses and seminars also.

As Table 9:1 shows, the Corporation has approved, from its inception in 1958 up to the end of the fiscal year 1967/68, 177 projects amounting to about Rs. 107 million.

It is encouraging that, of the loan applications received so far from private industrialists, many have come from small and medium-scale industrial enterprises promoted by Nepalese nationals. More than 30 per cent of the Corporation's financial assistance during the fiscal year 1964/65 went to new industrial concerns, while 67 per cent went to the expansion and modernization of existing ones.

In a country like Nepal, with the general sluggishness of its private sector in the process of economic growth, it is necessary to have an intensive publicity campaign in order to give it proper encouragement. Therefore, the Corporation as the first development bank of the country has actively undertaken promotion and publicity activities also. Efforts so far have been directed towards

TABLE 9 : 1

FINANCIAL OPERATIONS OF NEPAL INDUSTRIAL DEVELOPMENT CORPORATION

(From 1959/60 through 1967/68)

(In Thousands of Rupees)

Particulars	1959/60	1960/61	1961/62	1962/63	1963/64	1964/65	1965/66	1966/67	1967/68	Total
1. Number of Projects Approved	2	5	9	11	33	38	24	32	23	177
2. Approved Amount	411	870	5,247	19,321	10,210	24,922	5,746	32,673	7,913	1,07,313
3. Average Amount per Project	205	174	583	1,756	309	661	239	1,021	344	606
SHARE PARTICIPATION										
Commitment	299	470	700	250	1,017	899	680	2,750	155	7,220
Disbursed	299	470	700	100	874	350	1,230	572	339	4,934
LOANS										
Approved	112	400	4,547	19,071	9,193	24,023	5,066	29,923	7.758	1,00,93
Approved Adjusted	112	375	4,547	19,071	8,958	21,762	5,066	29,923	7,758	92,598
Disbursement	112	375	3,184	4,654	5,907	9,055	8,134	8,360	3,891	43,672
Owner's Participation	368	428	2,887	34,657	10,247	19,410	3,306	9,892	4,711	85,906
Owner's Participation Adjusted	368	374	2,887	34,657	9,760	16,336	3,306	9,892	4,711	78,539

Source: NIDC Annual Reports.

the focusing of investors' attention on the many investment opportunities in Nepal, the facilities provided to industries by the Government and the various other kinds of assistance. For example, one of the important achievements during the fiscal year 1964/65 was the organisation and successful conclusion of the first Industrial Conference which was attended by forty-five representatives and eighteen observers representing all the fourteen zones of the country.

By far the most impressive expansion of the Corporation's activities has been in the sphere of feasibility surveys, project analysis, market studies and allied fields. A number of market and/or technical feasibility studies have been carried out—some by the Corporation itself and some through foreign consulting firms. The studies included so far have been straw-board, tannery, bone meal, animal fat, brewery, paper and paper products, chip-board and plywood, ropeway, wool manufacturing, tea plantation and processing industries.

The Corporation has also conducted a number of industrial potentiality surveys of a number of districts where the Land Reform Programme has been in operation. Project analyses relating to loan applications are generally done on the basis of systematic and co-ordinated project appraisal. In some cases also, on the request of the Government license applications are appraised, and this has proved to be quite helpful to the Government for taking sound and well-conceived decisions.

As in most developing countries in Asia, Latin America and Africa, this institution in Nepal is a reflection of the growing urge for rapid economic development and of the search for machinery which can be used where development does not appear to be proceeding by itself with the desired speed. During the short period of its existence, the growth of the Corporation has been well maintained in all its spheres of activity. With this Corporation showing an operating profit, it should be possible to induce the private sector to begin contributing to the equity stock of the NIDC. In the overall context of the increasing investment facilities and other necessary concessions afforded by the Government, this first development bank has been considerably assisting the private sector in the establishment of several consumer goods industries; and the growing confidence of private investors in its operational activities has been to

a great extent instrumental in widening the scope of its achievements. In financial activities, particularly in the supervision of the working of the clients, it still has to play a more effective role.

INSTITUTIONS FOR PROVIDING FINANCE TO THE COTTAGE AND SMALL INDUSTRIES

In the private sector, the development of cottage and small industries is also important. The Cottage and Small Industries Department of His Majesty's Government may in this respect also be treated as a financial institution, as it makes funds available to such industries. In 1956 the Cottage and Small Industries Board was created, and most of the loans to such industries, instead of being directly advanced by the Department of Cottage, Village and Small Industries, are being sanctioned by the Board, after a proper scrutiny of the property and other related subjects. Its development is especially important since these industries provide the rural areas employment opportunities. The limited funds at its disposal and the limited number of trained personnel have so far restricted its financial operations. The disbursement of loans which amounted to Rs. 172 thousand during the First Five Year Plan (1956/57-1960/61), increased by only Rs. 346,000 in 1962/63, Rs. 317,000 in 1963/64 and Rs. 1.1 million in 1964/65. The loans outstanding at the later date amounted to Rs. 1.7 million. Most of these loans have been given to cotton, woollen and carpentry industries, and the bulk of loans is concentrated in the Bagmati zone. This trend makes it necessary that efforts should be made to disperse the loan activities to different parts of the country.

The Department also conducts loan-financing business through its Loans and Investment Sub-Committee, and has been functioning under Rules enacted in March, 1962. It can give direct loans, participate in shares and debentures and can promote new industries. The Sub-Committee is authorized to extend loans from Rs. 50,000 to the limit of Rs. 200,000. The loans have to be paid back within the maximum period of ten years on an instalment basis. As a rule, applicants seeking financial assistance are required to invest 10 to 25 per cent of the capital themselves.

By mid-July 1965, the loans and investment fund amounted to Rs. 1.9 million, which was received entirely from US-Aid grants. The Department has five zonal centres, in Sagarmatha, Narayani, Gandaki, Lumbini and Mechi zones, each of which is provided with a fund of Rs. 25,000 and is also authorized to extend loans of up to Rs. 5,000 per industry. Other zonal centres are also in the process of installation.

Considering the importance of developing small industries in an economy like that of Nepal, current efforts do not seem to be quite satisfactory. There has been a proposal that, as in the case of the Industrial Development Corporation, so in case of small industries a separate Corporation would also contribute considerably to the development of agro-industries.

The low level of national income in a developing country generally implies a high propensity to consume. An overwhelmingly large section of low-income earners has hardly any capacity to save. This becomes all the more difficult in the presence of the non-monetized sector, which in a country like Nepal constitutes more than 60 per cent. Therefore, efforts should be made on a planned basis to have institutional arrangements for rural credit also.

The credit requirements of the rural sector can be listed in a number of different ways. A large part of the agricultural population of Nepal, particularly in the hills, ekes out a bare subsistence from the limited cultivable area at their disposal. Poor weather conditions, for example, will occasionally reduce output below these minimum levels. Credit is therefore needed to tide the culivator over from the point at which his harvest runs out until the next harvest is gathered. The problem with this kind of credit is readily apparent. If, through inability to provide for basic food requirements, the cultivator has no ability to repay the loan, what is needed under the present conditions is either an opportunity for him to earn additional income during the agricultural slack season, or a shift of the population away from the area, or the input of the supplies necessary to increase output.

Again, consumption credit to cultivators in years of poor weather conditions and other calamities is economically feasible and beneficial to the nation. In normal years, we assume that the cultivator grows more than enough to feed himself and his

family. A poor crop is then a temporary phenomenon, and consumption loans can be repaid out of the expected normal crop the following year. There is no assurance, however, that poor growing conditions might not continue for two or more years in succession. Under these circumstances, consumption loans may have to be converted into longer-term loans for feasible repayments.

Credit with which to purchase imported or additional production inputs is basically self-financing. Improved seeds, fertiliser, small agricultural implements, and pesticides are some of the examples. Repayment can be made out of the additional output from the use of these purchased inputs. Up to the present, however, it appears to be more the non-availability of the inputs rather than the lack of funds which has been the limiting factor in the over-all strategy of the development of agriculture and agro-industries. With the establishment of the Agricultural Supply Corporation, the importation and also production of improved seeds, and the incentive prices which are prevailing, credit requirements are likely to expand quite rapidly.

Medium- and long-term credits are also quite necessary. In Nepal, substantial expenditure for meetings, weddings and other special occasions are a feature of local culture. Cultivators often borrow to finance the ceremonies. The amounts borrowed are of such magnitude that repayment must normally be spread over several years.

Purchase of agricultural implements (tractors), bullock carts and other capital items, and the construction of tubewells and minor irrigation works must often be financed with credit. Where market conditions warrant and credit is available, tractors have been purchased by larger cultivators and landlords. An instance of this is in Birganj, a *tarai* region. Bullocks provide the native power, particularly in the *tarai*, for most of the heavy cultivation work and transport to and from markets. The Agricultural Implements Factory, already completed with Russian assistance, produces ploughs, harrows and other related items. Cultivators will need credit to buy these improved implements also. Credit for agricultural products which have a long production period, e.g. tea, horticulture (fruit production) and agricultural processing is also required. Land ownership by cultivators is a widely-desired social goal and will itself provide

greater incentive to the cultivators. Credit will be needed to finance the purchase of land by the present tenants. Funds were needed to clear and level the land, provide the basic infrastructure, and finance the cultivators for the first year or two.

Cottage and village industries can provide additional income to the rural sector. Hand and power looms, milling equipment, and other capital items are needed to enable small-scale producers to compete with the large-scale manufacturing units. Such activities often supplement agricultural income.

All the above requirements can be met in different ways. Consumption loans to subsistence cultivators and for ceremonial purposes have no productive effect. Therefore, given the limited resources available, the Government should not be expected to provide credit or subsidies for these purposes. This raises a serious question concerning compulsory savings in some areas of Nepal, particularly the hill regions.

THE LAND REFORM SAVINGS CORPORATION

The experiences of sixteen districts where land reform was implemented, during the first year with compulsory savings under the Agrarian Act of 1964, provide some interesting indications. In the hilly districts, most of the savings collected have been lent out, primarily for consumption purposes. In the *tarai* region, relatively little of the total collections have been lent out to the needy agriculturists. If the borrowers in the hilly areas are the subsistence cultivators, they will have difficulty in getting out of debt. Under the existing rules, they must repay their borrowings in the second year and make another contribution under the compulsory savings programmes. If they must borrow virtually the full amount in the second year, they will simply keep going deeper into debt. It will only be after the fifth year, when repayment on the compulsory savings starts, that they may be able to stop repaying or, if the savings programme is continued, stop going deeper into debt. A study needs to be made of this matter to recommend possible changes or improvements to avoid this difficulty.

To stimulate the expansion of agricultural output and a rise in real income levels, credit will be needed for the other uses, discussed above. These are short-term loans to overcome tempo-

rary shortfalls to purchase improved seeds and other factor inputs, and long-term loans for capital items, land purchase, resettlement and village industries.

We have mentioned that, under the land reform programme, a new scheme of compulsory savings was introduced and "this has been an integral part of land reform programme and is designed to fill the credit vacuum likely to be created through the implementation of the programme."[6] This was designed to provide an alternative source of credit to cultivators and to mobilise domestic capital. The cultivators should save to invest in the improvement of their farm operations. Compulsory savings are collected by a committee established in each of the wards of Village *Panchayat* in areas where Land Reform measures have been implemented; by now the land reform programme has covered the entire country. The tenants and the landowners contribute a portion of the output in cash or in kind. This will be the capital of the programme. For food crops the contribution is in kind; for cash crops it is in cash. The depositors are to receive their accumulated savings in cash or the equivalent in shares of the credit institution after five years. It needs to be emphasized that the collection or mobilisation side of the scheme has met with some success; but the utilisation has been beset with a number of difficulties. Therefore, to ensure the effective use of the savings fund for stated purposes, and to supplement the efforts of the existing financial institutions, the Land Reform Savings Corporation was established in December 1966. It is expected that this corporation will be able to manage more effectively and to utilise throughout the year the savings already collected and accumulating year by year in agricultural, agro-industrial and other priority sectors if they are monetized and properly centralised.

THE COOPERATIVE BANK

Cooperative societies and the Cooperative Bank provide agricultural credit. The Cooperative Department of His Majesty's Government has the responsibility of encouraging the establish-

[6] P. K. Shrestha, 'Compulsory Savings', in *Land Reforms in Nepal*, Ministry of Land Reform, Kathmandu, 1968, p. 24.

ment of cooperative societies and supervising their operations. Available data on co-operative societies do not provide a very useful measure of their effectiveness, since many of the units registered with the Department are generally inactive. Their activities to date do not show much sign of achieving the expansion necessary to meet the credit requirements of the cultivators. To train the supervisors (sub-inspectors) necessary to cover the countryside effectively, cooperatives will require both a radical revision of the existing training programme and a considerable period of time, probably a matter of years. The Cooperative Bank was established under the Cooperative Bank Act of 1963, and is designed to help finance the agricultural reorganization programme and to provide credit to cooperative societies. As at mid-July 1965, out of its authorized capital of Rs. 5 million, Rs. 4 million was subscribed by the Government and cooperative societies.

The Bank extends short-term (six to twelve months), medium-term (one to five years) and long-term (up to fifteen years) loans to cooperative societies. A cooperative society or union must be a member of the Cooperative Bank to avail itself of financial assistance from the Bank. To become a member, a cooperative society must purchase at least one share of the Bank for each 100 members or fraction thereof and a cooperative union must also purchase at least one share per member society. In addition, an eligibility condition for borrowing requires a cooperative society or union to own at least one share per thousand rupees borrowed. The Bank has been charging different rates of interest for different purposes.

The Bank's outstanding loans increased from Rs. 786,000 in mid-July 1964 to Rs. 4.6 million in mid-July 1967. A major part of the loan has been used for agricultural production, construction of warehouses and rehabilitation in the Nawalpur district in the *tarai*. The Bank is at present concentrating its activities mainly in the Budhabare village of Jhapa district where intensive land reform programmes are being carried out. It has already established two offices, one each in Dhangadhi (Kailali) and Bhadrapur (Jhapa). The loan operations undertaken by the Cooperative Department have been handed over to the Bank in 1963.

Between the fiscal years 1961/62, and 1965/66, 859 additional

cooperative societies were established, bringing up the total number of societies to 1,440 with membership of 51,879 persons and paid-up capital of Rs. 2.3 million. At the latter date there were 1,046 multi-purpose cooperatives; 256 cooperative credit societies, 44 cottage industry cooperatives, 40 consumer co-operative societies, 21 marketing and credit societies, 6 dairy cooperatives and 27 other types of cooperative societies.

Four zonal cooperative offices were established to supervise and organize the existing and new cooperative societies and to provide prompt credit facilities. During the period from 1961/62 to 1963/64, loans disbursed by the Cooperative Department amounted to Rs. 5.2 million, whereas outstanding loans increased from Rs. 1.8 million to Rs. 3.1 million between mid-July 1961 and mid-July 1964.

Provision of adequate institutional credit facilities to the agricultural sector assumes special importance at present as the flow of the traditional source of agricultural credit is reported to have been considerably reduced due to the enforcement of the debt provisions of the Lands Act, 1964. The vacuum so created should be filled up by the Cooperative Bank and other official institutions to prevent adverse effects on agricultural production such as which would be likely to occur if normal credit requirements are not provided. Yet this has been the most neglected field. As at mid-July 1965 the aggregate outstanding loans of both the Cooperative Department and the Cooperative Bank amounted to a mere Rs. 4.3 million.

All the registered cooperatives that have acquired at least one share of the bank are eligible for loan provided they fulfil such conditions as are prescribed by the Bank. The following are the types of loans provided by the Bank to cooperatives: production loans, marketing loans, loans for consumers' services, and cottage industries loans.

THE AGRICULTURAL DEVELOPMENT BANK

As the agricultural sector predominates in the Nepalese economy, the unorganized money market has occupied a vital position. Money-lenders have been the most important sources of agriculture finance in Nepal, in spite of recent efforts towards the establishment of institutional arrangements.

There are professional as well as non-professional money-lenders who can be classified as rural and urban. In addition to the professional money-lenders, wealthier agriculturists, merchants, landowners, and others lend their surplus funds. A money-lender generally advances loans for both productive and consumption purposes. The loan thus provided is either in cash or in kind. Some borrow from them to procure necessities, agriculturists do so to continue agricultural operations and non-agriculturists to carry on trade, industry and commerce.

The money-lenders supply loan on personal security, if it is of a short-term nature. Physical security is needed for longer-term loans. Moreover, he loans his money on the security of crops, immovable property and gold and silver. Money-lenders in Nepal finance the trade in agricultural produce, and also conduct agricultural trade in retail shops. One of the purposes of the Land Reform programme has been to break the power of this historically dominant minority. It is high time that alternate sources of credit were provided in the economic development of the country.

It was in the fitness of things that, in October 1967, the Cooperative Bank was converted into the Agricultural Development Bank, with authorised capital of Rs. 50 million, as the main financing institution for the rural, small agro-industrial and co-operative sectors. The Bank has been entrusted with the responsibility of discharging functions and following commercial policies and principles such as are conducive to agricultural development. The Bank has the functions of providing short-, medium- and long-term loans on prescribed conditions to individuals, cooperative societies and corporate bodies for the purpose of agricultural development; making available to peasants fertilizers, implements, machines, pumps, insecticides and other resources needed for such development; making investments in minor industries processing agricultural commodities and in industries producing goods required for development; undertaking the banking functions mentioned in the 1964 Commercial Bank Act with the approval of the Nepal Rastra Bank for the purpose of 'extending normal banking facilities to the public in rural areas;' and performing such other functions as may be prescribed by the Government from time to time after consulting the Board for the purpose of fulfilling the objectives of the Bank.

The Bank is expected to manage the compulsory savings collected under the Land Reform Measures. However, the relations between the Bank and the Savings Corporation will present a problem, since the latter was recently set up. The lending rules of the Bank will also have to be properly framed so that a clear distinction is made to solve the problem of repayment, an aspect hitherto usually neglected in all such banking activities.

The establishment of the Agricultural Development Bank has justified itself by proving that the credit problem of agriculture cannot be solved through the cooperative societies alone. It makes it further clear that the Cooperative Bank with its principles could not solve the problem of normal credit requirements. It is true that "the continued insistence to enforce from the top has been the bottleneck of Cooperative Societies' development. All the high hopes of Cooperative Movement did not come true and bitterly realised that it takes time to enlighten the farmers in this regard."[7]

Apart from institutional considerations, the establishment of the Bank provides a major step towards the development of agricultural production. More than 65 per cent of the national income comes from agriculture, and the successful implementation of any Plan, which seeks to increase agricultural production is bound up with the fast progress in this sector. This will be helpful in boosting up agricultural production. The practice of borrowing for consumption purposes will have to be restricted, as this magnifies the obstacles to the use of production credit. The Bank's future plans to open branches in every district and village *panchayat* will help encourage the enthusiasm of the peasants to increase agricultural production. However, it is also desirable that the resources centralised in the Savings Corporation should be made mainly available to the Agricultural Development Bank.

THE INSURANCE CORPORATION

The Life Insurance Corporation also contributes to a considerable degree in mobilising the savings and credit structure on the long-term basis. However, it was only as late as February 1968

[7] K. N. Pyakurel, 'Agricultural Development Bank' in *The Rising Nepal*, Kathmandu, September 14, 1967.

that the Nepal National Insurance Company was set up. No doubt, this marks one further step in the financial field with the full realisation of its significance in the country's economic development. It has authorised capital of Rs. 2.5 million—HMG, the Rastra Bank and the Nepal Bank subscribing shares amounting to Rs. 1.3, Rs. 800,000 and Rs. 300,000 respectively. Although the venture has had a quite modest beginning with the very limited capital at its disposal, it appears that the Corporation has quite appropriately decided against stretching its hands too far and wide. Its activities are at present to be confined to insuring things without life, although in the near future it may decide to take up life insurance also. At present it can write the Fire, Marine, Motor and Casualty coverages under its general policy. As it stands, to start with, the Corporation may be in a position to conduct its business by enlisting the cooperation of the government-owned corporation, but "its popularity depends upon the facilities to be offered to the various parties as it has to stand on the healthy competition before so many Indian Insurance Companies now existing in Nepal which approximately collect Rs. 6 million as part of a premium per annum."[8]

THE PROVIDENT FUND CORPORATION

The Provident Fund Corporation was incorporated under the Provident Fund Act of 1962. The resources of the Fund consist of grants from the Government, deductions from the salaries of government employees, and the interest income earned. The assets and liabilities of previous provident funds run by the Government have been transferred to this Corporation. No government employees are permitted to withdraw the funds they have deposited until they retire or leave the service. The Corporation, whose funds are quite substantially increasing, has been utilizing its resources as follows: to invest in government bonds and undertake the sale and purchase of such bonds, to invest in industries, development projects and other activities sponsored by the Government, and to provide loans and advances to government employees in accordance with the terms and conditions as prescribed by the Act.

[8] K. Manandhar, 'Nepal National Insurance Corporation', in *The Rising Nepal*, Kathmandu, March 8, 1968.

AN APPROACH TO THE CAPITAL MARKET

The capital market in Nepal is at present in the process of transition, and a dynamic approach seems to be desirable at this stage. However, in the absence of the right type of financial institutions in the country, one can only suggest that there should not be an excessive diversion of the resources of the commercial banks into short-term activities alone. As in Germany and Japan, efforts could be made in Nepal also to have an increasing contribution to the types of investment most needed by the economy made through the banking institutions. With the fastest rate of economic growth among the capitalist countries of the world, Japan has a unique system of banking and monetary policy. High corporate profits, high rate of corporate investment and an ever high demand for bank loans—all these have led to a permanently over-extended position for the Japanese banks. For example, in Japan after 1942 every orthodox tenet of central banking was violated and the banks took on every conceivable financial chore including long-term industrial financing. West Germany is another country where the banking system has been adopted to provide development finance to various sectors of the economy, and mixed banking is widely practised.

Of course, since the financial institutions have to play an important role in our economic development, it might be argued that in the existing conditions in Nepal also a similar working of such institutions be justified. So far, as explained above, the branches of the commercial banks are dealing with short-term credit, and the various other financial institutions which deal with long-term credit are very few and far between in relation to the desirable rate of expansion of the private sector. In the country there has never indeed been a very close alliance between industry and the financial machinery.

The English banking practice is justified in England because the situation there is the outcome of history. However, conditions are quite different in Nepal. First, commercial and trading activities have not developed much even now, so as to make the banking structure adapt itself to the needs of trade and commerce; and secondly, the private savings available for industrial concerns are quite negligible and rising only very slowly, thus there are no accumulated projects. Therefore, the emphasis on

short-term finance alone is not appropriate for present conditions in Nepal. With the paucity of indigenous finance, the English banking system adopted hitherto cannot be regarded as adequate. At the same time, however, even if, in view of the paucity of industrial finance, economic circumstances do not seem to dictate that the commercial banks should associate themselves directly, as in Germany, with the country's industrial development, industry should nonetheless count on their direct support and guidance.

In view of the difficulties and the very slow growth of the monetized sector in Nepal, there should be specialisation respectively in short-term and long-term finances by different institutions. There appear to be in particular two reasons why in the existing conditions a mixed banking system may not be helpful. First, already even in the evolutionary stages over the last almost six years, a number of specialized financial institutions for providing short-term and long-term loans have already been set up in the country and have started operations; any change in their present structure would certainly mean readjustment in their functions which might entail unnecessary losses and even waste of time.

Secondly, with the predominance of the indigenous banking system in various parts of the country which are outside the monetary sector, and literacy reaching only slightly more than 11 per cent, the general masses are wedded to age-old customs and traditions. If, under these circumstances, changes are made often, confusion and misunderstanding might be created among the people, which would be to the detriment of economic growth. Therefore, although the mixed banking system which has been fully successful in other countries might not be helpful in accelerating industrial development in Nepal, it would however be advantageous that the Rastra Bank, as coordinator of the overall banking and monetary activities of the country, should come to the rescue from time to time to help the specialised financial institutions solve their various problems.

THE RASTRA BANK AND FINANCIAL INSTITUTIONS

At this stage we can discuss at some length the role of the Rastra Bank in the capital market of the country. It was discussed

in the preceding chapters how, to provide for the proper growth of the money market and so give monetary policy a meaningful content, the Rastra Bank as the central bank of the country has to play a dynamic and effective role in the capital market, which has only recently started in Nepal and is evolving very slowly. In this respect, the Rastra Bank should try to have more direct control of institutional finance, with a view both to helping existing institutions to grow on a sound basis and contributing to building up new institutions like investment houses, construction or building societies and other necessary long-term lending institutions.

Here one can note that, starting from in early 1968, some modest steps have already been taken in this direction. The Rastra Bank had created a separate agricultural fund in the fiscal year 1959/60, and since then a certain portion of profit was being appropriated to this fund every year. On July 15, 1965, an agricultural credit fund and an industrial credit fund were created, each with a sum of Rs. 2 million. In the fiscal year 1965/66, again out of the net profit, Rs. 6 million was put aside for the development fund after amalgamating the industrial and agricultural credit funds. The development fund, with total resources of Rs. 10 million, will be utilised for providing financial assistance to the existing financial institutions of the country. Again, Rs. 2.5 million was allocated to the newly created banking development fund which is being used for assisting the commercial banks in their efforts towards extending banking facilities in unbanked areas.

The Rastra Bank has created these special development funds in order to provide assistance without any inflationary impact. These funds, according to present indications, will be utilised to make available medium-term loans and also for equity participation. Short-term credit, also, can be provided by the Central Bank even by creating money up to the annual safe limit determined from time to time, after taking into consideration the current economic and monetary situation of the country. With the increasing tempo of trade and commerce in comparison with past years, more short-term loans might be needed for the commercial banks, which could further increase, depending on the nature of the development projects initiated by the banks. The Rastra Bank should see that there is a clear-cut line of

demarcation between the commercial banks and the non-banking financial institutions dealing with medium-term and long-term loans. The Rastra Bank itself should try to fulfil the demand of other financial institutions for loans out of its special fund. Since, this fund has been created out of the amount which would otherwise have been given to the Government by way of dividend, this is by no means tantamount to additional creation of money; thus the possible effects on economy of extending long-term loans can be considered from more than one angle.

So long as the banks and other financial institutions do not completely utilise medium- and long-term resources, it is obviously not advisable for the Rastra Bank to proceed too far in this field. But in the changing situation brought about by economic growth in Nepal, the time has come to probe into the reasons why the full utilization of all available resources has not been possible so far. Under-utilisation of institutionalised savings and frequent requests to the Rastra Bank for loans by financing institutions, even to extend short-term agricultural credit, are indicative of certain financial short-comings. Too many tiers in the rate of interest for the borrowing and lending of funds imposes a burden on borrowers as well as intermediaries. Therefore, to avoid this duplication of financial activities, the Rastra Bank should be fully aware of all the difficulties arising in institutionalised transactions, and should try to help the various non-banking financial intermediaries, not directly of course, but by re-financing. In 1968 the Bank had already adopted a new policy of having equity participation in the financial institutions. Examples are provided by its investment in the equity of three non-financial or non-banking financial institutions. These three are i.e. the Agriculture Development Bank, in which the Rastra Bank has subscribed Rs. 2.5 million as the equity participation, the Nepal Insurance Corporation (Rs. 8 million) and the Nepal Industrial Development Corporation (Rs. 4.1 million). In all these corporations there should be representatives from the Rastra Bank, and in that way it might be possible for the Bank as a Central Bank to have a proper co-ordinated supervision over the country's financial and economic activities, with the objective of development with stability. Of course, the majority of newly created financial institutions in Nepal, either Government-owned or operated in participation with the private sector, have not been

moving altogether satisfactorily. The Rastra Bank's direct relations with them help greatly in making available to them proper guidance and supervision. In fact, it is only through this type of participation that, with the passage of time, other important types of non-banking financial intermediaries like hire-purchase companies and building societies can be gradually established in the country.

Thus it becomes clear that one of the important responsibilities of the Central Bank is to ensure that all these different types of non-banking financial intermediaries should be made to move along in accordance with the approved monetary policy of any given time, and that conventional monetary control will have to be reoriented and should be introduced in such a way as to cover the activities of these institutions, in addition to commercial banks which deal merely with short-term finances.

10

THE EXCHANGE RATE AND ECONOMIC GROWTH

For any country a correct foreign exchange rate might prove to be a tool for economic growth. The rate of exchange in a country affects not only the volume and value of export and import trade but also internal transactions and the entire economy. A reduction in the external value of the currency of a country (i.e. devaluation) or appreciation in its value (i.e. revaluation) have manifold implications for the economy of a developing country. Generally speaking, devaluation is regarded as a tool for correcting adverse international payments.

Free dealings in foreign exchange, which were suspended in 1939, were restored in the course of the 'fifties in most of the financially advanced countries of the world. Most countries now have fixed parities, and in most countries foreign exchange is not as free as it was between the Wars. Today "exchange stability is maintained not by means of private gold at arbitrage but by means of systematic official intervention in the foreign exchange market."[1] In principle, the official intervention takes the shape of limited convertibility of the foreign currency with regard to sale and purchase by the public for specific purposes. This chapter seeks to analyse the external value of the Nepalese rupee against some historical background, and to focus on recent exchange rate policy with its bearing on the country's monetary situation and economic growth.

[1] Paul Einzig, *The Text Book on Foreign Exchange*, Macmillan, London, 1966, p. 13.

FOREIGN EXCHANGE REQUIREMENTS

In the development plans of Asian countries, a common characteristic is a high foreign exchange component. Despite their attempts to develop a capital goods sector, a substantial reduction in their import needs is improbable in the near future. The foreign exchange requirements of the plans are estimated to be (both for public and private sectors) as high as 59 per cent in Ceylon, 42 per cent in the Philippines and 34 per cent in Pakistan. For a developing economy, there is always a great need for external financial resources to provide foreign exchange, not only to finance the import components of the developmental programmes, but also sometimes for the supply of consumer goods. The size of Nepal's foreign exchange requirements has not been properly ascertained so far. The reasons are obvious: first, the major part of the requirements is met by Indian rupees, which have been circulating freely in some parts of the country alongside Nepalese rupees, in spite of the restriction on transactions in Indian rupees. Second, till quite recently (1960), Nepal had to depend on India for the provision of foreign exchange and had no control over foreign exchange earnings.[2] Naturally, the relevant statistical data on the subject were also lacking.

Before entering into the implications of the recent foreign exchange policy, it is relevant to examine briefly certain aspects of the dual currency system, which, in all respects, was in operation until April 1960. This was, obviously, affecting the country's monetary situation, and was detrimental to national economic interests. Until 1960, both Nepalese and Indian rupees were in circulation in all parts of the country, and in some districts in the *tarai* region only Indian rupees used to be accepted by the people and even by the Government in payment for dues. In such places, only Indian rupees were legal tender for all transactions. The Nepalese rupees were in use predominantly in the Kathmandu Valley and in the hilly parts of the country, while the Indian currency had been in circulation mostly in the *tarai* region and some adjoining regions of the interior.[3]

Particularly after the Second World War, the rate of exchange

[2] See Chapter VII p. 98.

[3] See my article 'Rate of Exchange in Nepal' in the *Economic Weekly*, Bombay, November 15, 1952, pp. 1179 - 1181.

between the two currencies used to vary from time to time and sometimes even from hour to hour in the Kathmandu market. Curiously, there were no reliable figures or even an estimate of the respective amounts of the two currencies in circulation before 1949. Generally, all such fluctuations used to be influenced by both seasonal and speculative factors; but they were also largely governed by the demand for and supply of Indian currency in Kathmandu. This dual currency system had been the real crux of the problem in any attempt by the Government to regulate the rate of exchange even after 1951 (before which date no such attempts were made). The evolution of these two currency areas is partly historical, partly geographical and partly economic in origin and, over the passage of time, they formed in practice a distinct feature of the Nepalese monetary system.

THE DUAL CURRENCY

The Nepalese rupee has had a chequered history in relation to the Indian rupee. The dual currency system in Nepal can be traced back to 1857, after which date trade in the modern sense started flourishing between Nepal and British India. Of course, as far as the circulation of Indian rupees as legal tender in Nepal was concerned, no formal declaration was made; and it was more by convention than anything else that even the Government collected its revenues in the *tarai* region in Indian currency and spent the same currency in the Kathmandu Valley, where primarily Nepalese currency used to circulate. However, there was no official control of the exchange rate of the Nepalese rupee against the Indian rupee whatever, and it used to be determined by market forces, often by a more handful of 'money changers' known in Kathmandu as '*Sarafies*'. In those days, however, the fluctuations in the exchange rate between the two currencies were not normally very wide and, for the Government's accounting purposes and other transactions during the nineteenth and the early part of the twentieth century, the rate of exchange used was approximately Nepalese rupees 128 for 100 Indian rupees. There was, of course, no valid and well-founded reason for this ratio.

AFTER 1930

Upto 1930, the exchange rate of the Nepalese rupee in relation to the Indian rupee in the Kathmandu Valley used to remain 100 Indian silver rupees for 125 Nepalese rupees, while Indian currency notes were at a slight discount, the rate being the 100:128 mentioned above. The fluctuation was negligible and it was not a problem, of course, from a short-range standpoint and in relation to the government economic policy, which was geared only to the maintenance of general administration. This relative stability was primarily due to two factors. First, Nepalese currency in those days consisted entirely of silver coins of different denominations, paper currency being issued by the Government only in 1943. Secondly, demand for Indian currency was small, as imports from India under the family rule of the Ranas came within the over-all context of restricted trade and isolation. Trade was thus extremely limited, being confined only to such essential commodities as raw cotton, textiles, salt, kerosene, and medicine. However, after the early 'thirties, with the increasing impact of outside forces, a policy with some semblance to liberalism was adopted in matters of imports, and this had its resultant implications for foreign trade also. Along with the rise in imports, the value of Nepalese currency fell in relation to Indian currency, the exchange rate at the end of 1932 even dropping to 132 Nepalese rupees for 100 Indian rupees. Subsequently, as a result of a policy of further liberalisation of imports, the ban on a large number of articles like motor cars, radio sets and alcohol was gradually lifted. The process of increasing imports into Kathmandu continued, mostly from India, until by 1939 the rate of exchange had reached 145 Nepalese rupees for 100 Indian rupees.

THE SECOND WORLD WAR AND AFTER

Since the volume of imports remained almost unaffected by the outbreak of the Second World War, this event had almost no effect on the rate of exchange. After the fall of France, however, there was a mild panic and a loss of confidence in the Indian rupee, which resulted in an appreciation of the Nepalese rupee to a rate of 126 for Indian rupees 100. The panic even led to the

closure of the so-called *'Sarafies'* money market in Kathmandu, the 'pulse' of the exchange rate, for a week, and the Government, for the first time, announced the necessity of controlling the rate of exchange at 128:100. Obviously, in the virtual absence of any statistical information, the fixing of the rate at this level was not backed by any adequate administrative machinery geared to cope with the situation. However, with the return of normal conditions, the exchange rate depreciated again to 134 Nepalese rupees for 100 Indian rupees.

Thus the exchange rate had returned again to its previous level. But with a further drop in imports, the value of the Nepalese rupee tended to rise, and by 1944 in the open market only 80 Nepalese rupees could purchase 100 Indian rupees. Besides the decline in imports, there were other more important factors operating at that time in favour of raising the value of the Nepalese rupee: the return of Nepalese soldiers with Indian rupees in their pockets following the climax of the War in South Asia, and the sharp rise in the price of silver, which led to a keen demand for Nepalese coins. Till the end of the War, the exchange rate fluctuated between 80 and 85 Nepalese rupees for 100 Indian rupees. Even in the post-war years, the trend towards the appreciation of the Nepalese rupee continued. Accordingly, by the end of 1946 the exchange rate varied between 65 to 70 Nepalese rupees for 100 Indian rupees. Heavy (invisible) export earnings in the shape of remittances made by Gorkha troops stationed outside Nepal were probably one of the main factors pushing up the rate of exchange at that time. In its anxiety to arrest further appreciation of the Nepalese rupee, the Government as a counter-measure issued for the first time currency notes of the denomination of 100, 10 and 5 rupees. As a consequence, the exchange rate came down within a few months to 90 Nepalese rupees for 100 Indian rupees. With the gradual increase of imports again, the value of the Nepalese rupee continued to decline still further, and by the end of 1950 the rate of exchange had reached 100 to 112 Nepalese rupees for 100 Indian rupees.

AFTER 1951

After the interim cabinet was set up by King Tribhuvan in

February 1951 following the political change, the exchange rate suffered from further violent fluctuations. The speculative dealings which had started a few years earlier in Kathmandu now became rampant as a result of the slackening of various restrictions in the new democratic atmosphere, and because the popular demand for imported commodities had considerably increased, and with it of course the volume of imports rose also. Some Ranas, who had been the main capitalists of the country, left Nepal along with their large capital assets. So there was not only a fall in foreign receipts, but a substantial flight of capital from the country. A process thus began of creating additional currency for meeting the budgetary deficit, which continued right until 1958. This also had a markedly adverse effect on the people's confidence in Nepalese currency. As the Finance Minister said in his budget speech for the fiscal year 1962/63: "Since the year 1950, there was deficit budgeting in most of the years, but no practical measures were adopted to meet the deficits by increasing government revenues. The accumulated deficit of 160 million rupees was met from surplus balances. The rate of exchange, therefore, continued to deteriorate steadily, the exchange dealings being marked by almost daily fluctuations."[4] Consequently, certain measures adopted by the Government from time to time, like that of September 1952 by which the Government fixed 128 Nepalese rupees for 100 Indian rupees as the official rate of exchange, and other more or less similar steps, did not have any positive effects.

It is instructive to note the steps taken by the Government in the context of the above conditions. When the exchange rate reached 145 in September 1952, without properly understanding the basic realities or studying the necessary implications, the Government experimentally fixed 128 Nepalese rupees for 100 Indian rupees as the official rate of exchange. Unfortunately, this official rate could not be maintained, even for a few months; it remained on the contrary just a pious declaration of intention. In July 1953 the Government was believed to have appointed a currency committee to report on the exchange problems, but nothing was subsequently done. The condition further deteriorat-

[4] Ministry of Finance, *The Budget Speech*, HMG., Kathmandu, 1962/63, p. 2.

ed, and by early September 1954, the exchange rate reached 189:100. It is presumed that this decline was above all due to a heavy excess of imports over exports mostly in the Kathmandu Valley. Moreover, an exchange rate at 128:100 that was granted for some specific purposes (as for students taking university examinations in India or people going abroad on pilgrimages), while the market rate stood at 180:100, meant a loss to the country of 52 Nepalese rupees on each exchange of 100 Indian rupees, and the Government also granted some loans at this rate to senior civil servants for the purchase of automobiles and for other similar purposes. All these in turn involved a loss.[5]

In September 1954, a twelve-point programme comprising licensing of currency for the purchase of essential goods from outside the country at controlled prices was announced, and the government exchange rate for the purpose was fixed at 149, at a time when the unofficial rate was fluctuating between 165 and 170 Nepalese rupees to 100 Indian rupees. In October 1954, the rate stood at 170:100.

April 18, 1955, witnessed another experiment with the release of a press note by the Government, which directed the Nepal Bank, then the only commercial bank, to function as an exchange bank for conducting buying and selling transactions in Indian rupees at rates to be fixed by the Government. A fifteen-point scheme was announced to check the soaring prices of essential commodities in the country and to stabilize Nepalese currency in relation to the Indian rupee. Under the Scheme, the Nepal Bank was to provide the necessary currency in Indian rupees at fixed exchange rates, facilitating imports of rice, paddy, gram, pulses, sugar, salt, woollen and cotton yarn, sewing thread, medicines, non-prohibited varieties of cloth, petrol, kerosene oil, books, newspapers, and magazines. The imports of cigarettes, matches, soap and stationery were cut by 50 per cent with immediate effect. All government servants, serving in the regions where Indian currency was in use, were to draw 50 per cent of their emoluments in Nepalese currency at the rate of 150 Nepalese rupees for 100 Indian rupees. The press note further added that, in places where Indian currency circulated, railway fares, and telephone and wireless bills could be paid in Nepalese

[5] Of course, the provision of foreign exchange by the Government at the official rate was limited to some limited purposes.

currency at the rate of 125 Nepalese rupees for 100 Indian rupees. Beginning from September 1, 1955, the Indian Airlines Corporation for air services was asked to accept air freight and passenger fares in Nepalese currency. All this clearly shows that by September 1955 various rates were operating in the country.

Even after it had been set up, the Rastra Bank was for several years unable to take concrete measures to rectify this hopelessly unstable situation. Of course, the imperative need for a central bank to bring about proper adjustment in the fluctuations in the value of money was adequately recognised. However, the absence of transport and communications, illiteracy and the primitive system of production, both in agriculture and industry, are hard enough obstacles; added to these, the complicated system of monetary circulation and issue hitherto prevalent in the country made the development of a proper banking system extremely difficult.

THE UNLIMITED CONVERTIBILITY

Against the background of continuous violent fluctuations and an almost continuous decline in the exchange value of the Nepalese rupee, certain *ad hoc* measures adopted by the Government to counter them from time to time either resulted in a net loss in revenue, or were lop-sided, limited and of short-term effect, unable to produce any lasting results. The result was that, for a long time, a dual currency system operated in Nepal. One writer has suggested: "During the period 1934 to 1960, the experience of Nepal, with a freely fluctuating exchange system, is not too different from the European countries in the inter-war period."[6] It was not until 1942 that any government step was taken, and the various unsuccessful *ad hoc* policies just referred to were taken from time to time up to 1959.

On April 13, 1960, placing emphasis on stability rather than appreciation of the value of the Nepalese rupee, the Government declared unlimited convertibility of Nepalese currency for Indian currency at the rate of 160 Nepalese rupees for 100 Indian rupees. The Government for the first time thus declared Nepalese currency fully convertible into Indian currency at an official rate

[6] P. N. Pant, *The Dual Currency System in Nepal,* (Unpublished thesis for Ph.D) Nashville, August 1964, p. 160.

for all purposes, and authorised the Rastra Bank to fix its rate of exchange within the range of one per cent either side of Nepalese rupees 160 and carry out selling and buying transactions in Indian currency freely. All internal dues payable to the Government, excepting those under contracts and royalties, were to be collected in Nepalese currency, except in five districts where banking facilities did not exist at that time. Thus, for the first time, the Government adopted a broad and comprehensive approach to the currency and exchange problems. Experience in the following years showed that through the fixing of the rate, there had been considerable success in achieving, even

TABLE 10 : 1

NC/IC EXCHANGE RATE

Annual Averages (1932-1960)

Year	*Annual*
1932	128
1933	129
1934	131
1937	144
1938	144
1939	148
1941	128
1942	124
1943	96
1944	91
1945	83
1946	71
1947	84
1948	103
1949	104
1950	104
1951	109
1952	131
1953	154
1954	164
1955	177
1956	152
1957	138
1958	159
1959	164
1960	161

Source: Nepal Rastra Bank.

TABLE 10 : 2

FOREIGN EXCHANGE RESERVES

(*Mid-July* 1961 *through Mid-February* 1969)

(In Millions of Rupees)

		Foreign Exchange Reserve (b+c)	*Gold*	*Foreign Exchange* (d+e)	*Convertible Currencies*	*Inconvertible Currencies* (f+g)	*Indian Currency*	*Others*
		a	b	c	d	e	f	g
Mid-July	1961	185.4	14.0	171.4	52.2	119.2	118.2	1.0
Mid-July	1962	215.3	14.0	201.3	76.4	124.9	124.0	1.0
Mid-July	1963	240.2	23.2	217.0	103.1	113.9	113.4	0.5
Mid-July	1964	361.8	23.2	338.6	145.2	193.4	193.0	0.4
Mid-July	1965	429.3	23.2	406.1	178.2	227.9	227.8	0.1
Mid-July	1966	356.5	25.0	331.5	231.3	100.2	100.0	0.2
Mid-July	1967	375.4	25.0	350.4	287.3	63.1	62.8	0.3
Mid-July	1968	524.6	70.7	521.9	402.8	119.1	118.7	0.4
Mid-February	1969	661.6	73.8	587.8	469.4	118.4	118.1	0.3

Sources: Nepal Rastra Bank.

though gradually, stability and strength in the rate of exchange and a unified national currency. This is seen from Table 10:1 which gives the annual average of the exchange rate.

It is remarkable that, following the fixing of the exchange rate with unlimited convertibility, the foreign exchange reserves held by the Rastra Bank went up from Rs. 185.4 million to Rs. 429.3 million, between mid-July 1961 and mid-July 1965, that is an increase of Rs. 243.9 million or 132 per cent. Thus the convertibility programme had a beneficial result in the country's economy. The increase continued, and the foreign convertible currency reserves increased between 1963 and 1968 from Rs. 103.1 million to Rs. 402.8 million respectively.

The circulation of Indian currency was declared illegal in most of the trading centres in the *tarai* region in the fiscal year 1963/64, and this was more extended in the following years. The years 1963/64 and 1964/65 have seen favourable terms of trade with India because of the steeper rate of rise in the prices of foodstuffs and agricultural raw materials in comparison with the rise in the prices of manufactured goods in India.

CASE FOR STABILITY

The Government thus assumed its important duty of maintaining the stability of the rate of exchange, for various reasons. First, it provides a stable basis for international trade, and facilitates the international movement of funds. The importance of international lending in the present-day world cannot be exaggerated. The developing countries, particularly those like Nepal, require enormous amounts of foreign capital for development activities, and we cannot attract foreign capital (other than in the form of aid) unless foreign investors are assured of maintaining capital value intact. Secondly, because of the unstable currency, our own people previously used to have all their savings in Indian rather than in Nepalese rupees, which had further weakened the position of Nepalese currency. Thirdly, fluctuating rates of exchange give rise to speculative elements in trading. Any fluctuations, particularly with regard to longer-term contracts, normally hinder economic progress. Finally, the old instability gave rise to the dual currency system, which had proved a serious handicap to effective and progressive financial admini-

stration. However, despite the Government's success in achieving stability in the value of the Nepalese rupee, its efforts to circulate Nepalese rupees in the *tarai* region were not effective for a few years afterwards. Of course, historical factors, the people's psychology and administrative inefficiency were the major obstacles.

But with the growing confidence of the people in the Nepalese currency as a result of the stabilisation of the exchange rate at 160:100, the Government felt that favourable conditions were being increasingly created in which the dual currency system could be practically abolished—gradually, of course, owing to the obstacles mentioned above. So far, Indian currency had remained in circulation in all the *tarai* areas adjoining India and in some of the mountainous areas. In the absence of any reliable statistics it is difficult to estimate the amount of Indian currency circulating in Nepal; it was estimated at around Rs. 200 million.[7] In these conditions, the Foreign Exchange Control Act of 1962 was put into effect from August 17, 1963, in twenty-one places both in the *tarai* and hilly regions, including the Kathmandu Valley. As from February 13, 1964, the Act was extended to three other *tarai* areas. Transactions in Indian currency were thus controlled in these areas, and the buying and selling of Indian currency were to be effected through licensed dealers only. As a result of all such measures, not only did the area in which Nepalese currency operate start widening the existing exchange, but they also assisted in gradually eliminating the dual currency system and paved the way for the introduction of a single monetary unit, i.e. Nepalese currency, all over the country.

MONETARY REFORMS

While the above measures were being taken to make Nepalese currency legally acceptable in different districts, other measures to provide the necessary basis for monetary control and management were being implemented simultaneously. The unification of the currency should provide greater scope for the employment of monetary, budgetary and foreign exchange policies

[7] Nepal Rastra Bank, *Annual Report*, Kathmandu, 1957 - 58, p. 10.

according to the long-run objectives of the Government than would otherwise be the case. It was this realisation which led to the creation of an independent central bank, the Nepal Rastra Bank, in April 26, 1956. One of the purposes of the Bank was to secure the country-wide circulation of Nepalese currency and to achieve stability in its exchange rate.

After its inception the Rastra Bank naturally had to face some troubles – such as an acute shortage of trained staff for the proper management and supervision of the affairs of a Central Bank. However, measures for strengthening monetary control were initiated gradually in the course of the following years. Nepal Rastra Bank notes were issued from February 19, 1960, although the minting of rupee and half-rupee coins, and those of smaller denominations is still done by the Government on the basis of requests by the Bank. The Foreign Exchange Control Act provides an important weapon in the hands of the Rastra Bank for bringing about the ultimate use of a single currency throughout the country. In a small underdeveloped country, highly dependent on the outside economy and possessing an undeveloped banking and financial system, mere unification of the currency alone does not solve the country's major financial problems; therefore to make monetary management effective and achieve more consistent reforms in the monetary and banking system, as explained above, a Commercial Banking Act, effective from May 13, 1964, was promulgated. This provided for better technical control by the Central Bank and better co-ordination of the activities of the commercial banks.

STRENGTH OF STABILITY

Above all, when there are two currencies in circulation in a country, over only one of which it has any control, it is difficult for the Government to develop and implement any consistent monetary policy such as would contribute to rapid economic development. As a matter of fact, such a state of affairs deprives the country of the savings element involved in the people's holdings of the external currency. Again, the existence of the other currency circulating freely in the country creates complicated problems relating to currency supply, exchange rates and even price movements. In Nepal before April 1960, fluctuating ex-

change rates between the two currencies had only added to the problems of monetary policy by creating an unstable element in the situation.

As against these, the process of unification of the currency by gradually extending the national currency area, in the context of its stability in value and the increasing confidence it enjoyed with the people, started to make a marked contribution to the overall development of the country's financial system. Over the last few years, some of the difficulties have from time to time been solved, or at least purposeful attempts at solutions are being made with growing experience. In fact, the stability with which it has been possible for this rate to be maintained since April 1960 has been in marked contrast to the early experiments, when there were wide and frequent fluctuations in the rate.

Thus, above other things, with the establishment of unlimited convertibility between the two currencies, the Nepalese currency area in the country seemed to have undergone a natural extension, and it was found that even in the Indian border areas of the *tarai* Nepalese currency was freely acceptable for petty transactions. This extension of Nepalese currency-using areas also enabled the Rastra Bank to expand the supply of Nepalese currency without fear of an inflationary impact. Above all, in any country a stable currency will be a remedy against any recurrent price rise and seasonal or speculative increase in Nepalese currency and Indian currency exchange rate, and would also foster more favourable trade relationship between Nepal and India.

However, the accumulation of increasing foreign exchange holdings in the Rastra Bank started showing signs that the Nepalese rupee was almost undervalued and that there should be a proper adjustment made by even slightly appreciating the external value of the Nepalese rupee.

APPRECIATION OF THE RUPEE

The figures given in table 10:1 show that before India devalued her currency in June 1966, Nepal's holdings of both Indian and convertible currency balances had been rising steadily. It is seen that convertible currency holdings increased from less than Rs. 10 million in July 1957 to Rs. 145.2 million by July 1964. Indian currency balances rose from July 1957 to July 1962 and declined

during the following year, but have almost doubled since July 1963.

On June 6, 1966, the Government of India devalued the Indian rupee by 36.5 per cent in terms of gold or 57 per cent in terms of dollars, pounds or roubles, i.e. $ 1 became equal to Rs. 5.70. In Nepal, in consideration of her own problems and conditions, the Government did not change its exchange rate with the convertible currency like US $ and £ sterling; but, as a result of the devaluation of the Indian rupee, the new exchange rate came to be maintained at Rs. 100.00 for Indian rupees 98.47 or I. Rs. 100 for N. Rs. 101.55, as against the previous rate of N. Rs. 160 for I Rs. 100. Of India's neighbours, Nepal—in common with Pakistan, Ceylon and Burma — did not devalue its currency following the Indian devaluation. As Prof. Lewis rightly says, "Devaluation, essential as it is once prices have got out of line, is something to be avoided if one can manage without it."[8]

Historically, as shown in the table 10:1, after 1960 the exchange rate between Nepalese and Indian rupees had remained consistently stable. It was being felt, however, that in the changing conditions and the developments in the various sectors of the country's economy, the rate was not realistic and needed some slight changes. Even if during the last few years the Government had been contributing a large portion to developmental expenditure from the surplus of current revenue over expenditure, without increasing budgetary deficits in the revenue account, there had been the growing accumulation of foreign exchange reserves every year. Since 1960 the foreign exchange reserves with the Rastra Bank increased from Rs. 137.8 million to Rs. 473.69 million in June 1966. During the same period the Indian rupee reserves increased from Rs. 82.13 million to Rs. 238.02 — almost threefold. Since mid-July 1965 foreign exchange holdings have risen by Rs. 44.43 million, or by some 10 per cent.

In addition, the effects of rising Indian prices on the Nepalese economy were becoming increasingly serious. Prices, of course, were rising in Nepal also. Between the end of July 1960 and the end of July 1965, money supply increased approximately by 65 per cent, the annual average increase within the five year period being 33 per cent. The prices of consumer goods other than

[8] W. Arthur Lewis, *Development Planning*, Harper and Row, New York, 1966, p. 52.

food grains increased by about 20 per cent from March-April, 1964 to March-April 1966 in the Kathmandu Valley. During the same period prices of food grains increased by more than 50 per cent. Generally, Indian price movements affect not only imports into Nepal but also domestically produced goods which enter the export market. After the revaluation, the foreign exchange holdings came down to Rs. 390 million, the Indian currency balances being worth Rs. 140 million at the new rate. This was still over 50 per cent of the estimated value of imports for the fiscal year 1965/66. It was expected (and later happened) that the revaluation would prevent a further rise in IC balances held by the Rastra Bank. Since the balances will decline, this will eliminate foreign exchange holdings as an expansionary factor affecting money supply. It was also expected to help liberalize imports from countries other than India.

Along with a decision not to devalue Nepalese currency, a series of follow-up measures to support and sustain the new exchange rate were announced simultaneously. The budget for the fiscal year 1966/67 accordingly emphasized a number of additional monetary and fiscal measures to maintain the new exchange rate.

APPRECIATION, REAL INCOME AND IMPORTS

It is relevant at this stage to analyse the effects of the appreciation on real income and imports. We can consider the groups affected as basically two—those dependent on agricultural activities for their income and others. For the first group, both incomes and prices were affected, at least in Nepalese currency terms. Although in large parts of the *tarai* region, where agricultural and consumer goods prices used to be quoted in Indian currency, the effects were virtually non-existent, in other parts the cultivators found that the prices of their products declined to almost the same level, making necessary allowances for transport costs, with those of the *tarai*. For those others whose incomes are not affected by agricultural prices, the revaluation raised real incomes. This gradually enabled all such consumers to buy more, both imported as well as domestically produced goods and services, and the volume of imports from India also rose significantly.

The decision not to devalue had, of course, a great significance

in Nepal's economy, since it raised a number of fresh problems before the country. First, it was quite natural that the new exchange rate should have raised imports from India, since the Indian goods became cheaper. At the same time, Nepal's exports to India would slacken; since, other things being equal, Nepal's goods would be more expensive for India to buy. Nepal then had and still has almost 90 per cent of her trade with India. The excess of imports over exports due to an unusual cause will definitely create a deficit in the balance of trade which will put pressure on foreign exchange reserves, particularly Indian rupees. Export prices in Nepalese currency would fall and adversely affect export performance, while, of course, the cost of imported supplies would decline. Therefore, it was necessary to raise the import duties on Indian goods, and to restrict their imports it was necessary to lower the export duties and to give relief in excise duties on the exportable goods produced inside the country. Considering all these aspects, the Government – only a fortnight before the budget session – made certain changes in the customs and excise duties. Further changes were effected by the Finance Minister in the budget on July 10, 1966, when he accepted that the new exchange rate had necessitated a fundamental change in the economic development, fiscal, monetary, industrial, commercial and agricultural policies, and that he had prepared the budget against such a background.[9]

With the objectives (i) of maintaining the balance between the interests of consumers and the necessary development of indigenous industries and commerce in the country and (ii) of rendering the new monetary policy more effective, a new tariff policy was adopted. For instance, among the goods of general use, a slightly higher import surcharge was levied on those produced within the country and a lower rate was levied on those not produced inside the country. But in case of essential goods of daily consumption no such surcharges were levied. A number of facilities, including abolition of excise duties, were provided to small and cottage industries, and facilities were given to large industries also.

[9] Ministry of Finance, *The Budget Speech,* HMG 1966/67, Kathmandu, p. 2.

NEW EXCHANGE RATE AND THE REVENUE

The new exchange rate obviously brought down revenue of the Government. To offset these implications in the budget for the fiscal year 1967/68 it became imperative to adopt a bold fiscal policy with a substantial surplus in the revenue. The revenue for the fiscal year 1966/67 was estimated to increase by Rs. 28.3 million or 12 per cent over than the revised estimates for the fiscal year 1965/66, while in the fiscal years 1963/64, 1964/65 and 1965/66 the increments were estimated to be 14, 22 and 16 per cent respectively. The estimated surplus from the current revenue and expenditure for the fiscal year 1966/67 was put at Rs. 82.5 million whereas, according to the revised estimates for the fiscal year 1965/66, this surplus was in the order of Rs. 71.8 million. There had also to be a 30 per cent increase in development expenditure in order substantially to raise our exports. But because of increased smuggling activities, which the almost traditional administrative machinery could not properly cope with, the actual revenue returns showed that there was a shortfall to the tune of almost 15 per cent.

Food grains and other unprocessed raw materials comprise about 70 per cent of Nepal's total exports to India. It therefore became all the more important that agricultural production should increase substantially to step up exports. The land reform programme started in 1964 had, of course, provided incentives to increase agricultural output by fixing rents payable by tenants to the landowners and by ensuring security of tenancy rights. The fixing of a ceiling on the ownership of land had started to give initial encouragement to the farmers to increase agricultural production. Even then, against the background of the then monetary policy, the Government recognised the need to provide facilities, as rapidly as possible more particularly the minor irrigation projects with a short period of gestation, use of improved seeds, sale and purchase of fertilizer, and credit facilities to farmers for augmenting agricultural production.

Right from the beginning in certain quarters, there was one opinion that the policy of the Government would lead to a substantial decrease in Nepal's exports and an unprecedented increase in imports. To some extent, of course, this was correct. As a result of an increase in the prices of imported articles from

India, it was natural for imports to rise. But since a large proportion of imports into Nepal from India consists of goods necessary for Nepal's developmental activities and for daily consumption also, and since some of them have quantitative quota restrictions, an unprecedented increase in imports can be ruled out. With regard to imports of luxury and semi-luxury goods, which form a negligible portion of Nepal's total imports, although a rise in such imports was inevitable and has actually increased, their increase might not occur in the same proportion as the increase in the value of Nepalese currency. The new tariff policy also neutralised this trend to a considerable extent.

Therefore, even because of the export inducement policy pursued by the Government, the tendency for Nepalese products to be exported to India will naturally persist in view of the country's geographical position and transportation hazards. Moreover, since 70 per cent of Nepal's total exports consist of foodstuffs, India will not reduce her imports from Nepal, as her import requirements of food grains in the present situation will generally remain as they are. This aspect was emphasised by the drought conditions in the fiscal year 1966/67 in the States of Bihar and Uttar Pradesh, and other states of India. And even though she will have to pay more, it will be to India's advantage to import from Nepal, as she can pay these in her own currency, while her imports from other countries will have to be largely settled in payments for convertible currency. However, there is no doubt that, if things remain as they are, the tendency for imports of Indian origin goods to increase will persist, and a reduction in Nepal's exports cannot be ruled out.

Commercial credit provided by the banks to the private sector plays an important role in the process of economic growth. Since such credit is provided by the commercial banks and other financial institutions, there is a need to regulate it in the greater interests of the country. It is evident that an excess or a flow in the wrong direction would bring about confusion in the economy and nullify the monetary policy of the Government. All necessary steps have, of course, been taken at appropriate occasions. Since a nation-wide banking system is a desired pre-requisite, steps were also taken gradually to set up various bank offices all over the country even in the remotest mountainous regions. The task of implementing the policy of a single national monetary system

throughout the country was started on October 18, 1966, by two phases.

Briefly, the new exchange rate between Nepalese currency and Indian currency has produced certain benefits. First, this change enhanced the prestige of Nepalese currency inside the country as well as in the international market. It is also helping Nepal follow an independent monetary policy, in keeping with her needs in future also. Although in the first three months Indian currency reserves in the Rastra Bank were being depleted quite fast, in the fourth month they again started increasing and after November 1966, with other seasonal exports including food grains, this tendency continued all the more. During the same period, convertible currency reserves increased by more than Rs. 20 million. Secondly, the new rate generally helped to arrest the trend of rising prices in Nepal emanating from rising Indian prices. It is estimated that during the first year, in spite of increased import duties, the general price level (including both Indian imported and indigenously produced commodities) fell by more than 15 per cent. Thus it had not only been off-setting the effects of imported inflation, but there had been a beneficial influence even on prices of commodities internally produced. The third benefit to the Nepalese economy was that this change would help to produce rapid economic development; in other words, the country would be able to attain more physical targets from the existing available resources. Of course, in the entire process of growth, this is dependent on co-ordination of a number of variables both in the public and private sectors.

DEVALUATION OF THE RUPEE AND ECONOMIC EFFECTS

However, in spite of all the above benefits, the heavy strain on the Indian currency reserves with the Rastra Bank went on rising, creating serious repercussions in the public mind. Statistical evidence, coupled with psychological apprehensions, feeding each other by a chain of reactions, created a vicious spiral, fraught with dangerous implications for the economy as a whole.[10]

In the meantime, on November 18, 1967, a timely devaluation of the sterling pound by 14.5 per cent gave an occasion to His

[10] R. P. Sharma, 'Devaluation – In Retrospect and Prospect', in *The Rising Nepal,* Kathmandu, December 31, 1967.

Majesty's Government for readjusting its exchange rate. Its subsequent action was based on 18 months' experiences after the Indian devaluation seen in the overall context of political, administrative and other economic considerations. Sterling, featuring as the second largest currency in Nepal's foreign trade, clearly provided sufficient ground to reconsider the exchange rate in a new context. Accordingly, on December 8, 1967, in view of this changed international situation, Nepalese currency was devalued by 24.7 per cent, with the simultaneous announcement of a number of follow-up measures. Because of our administrative incapabilities, this was regarded as a timely step by some, while others, for the sake of not generating into our economy any sort of instability, still advocated making all possible efforts to sustain the earlier exchange rate. It is argued that, with an over-all reduction of 18-20 per cent in tariff rates, the new policy appears to have given opportunities to border trading and business activities, thus giving them a fresh lease of life. It was further expected that the direction of invisible trade was also likely to change favourably and all taken together, would help promote public confidence in the stability of the currency.

However, its baneful effects should hardly be ignored or avoided. As Prof. Lewis says, "Devaluation raises the cost of imports, and therefore the cost of living. This provokes demands for higher wages and other incomes. If these are granted, part of all the devaluation will have been cancelled out by the increase of domestic costs. Granting these demands therefore raises the cost of living further, and so sets in motion the spiral in which prices and incomes chase each other. Most countries which resort to devaluation find that it is not a once-for-all, but at best a converging process, in which it takes a series of devaluations, some severe, to reach the desired equilibrium between the domestic costs and foreign prices, even though the original divergence may not have been very large."[11] Recent Indian experience has belied most of what had been originally expected, and this act was accepted after more than one year of devaluation by the Finance Minister himself. Therefore, for Nepal also the devaluation of the currency could hardly be judged in isolation from other internal and external economic variables which have

[11] A. Lewis, *op. cit.* p. 52.

to play significant roles in the process. The success of the policy depends upon the behaviour of wages, money incomes and prices, all of which will consistently have to be carefully watched. A revaluation affects certain fields of industry and trade, while devaluation affects the populace of the entire country in a very general way. This is a very important issue. As Prof. Lewis again emphasises, "Devaluation, essential as it is once prices have got out of line, is something to be avoided if one can manage without it."[12] In addition to other things, it is an affront to national dignity involving a loss of prestige, if the necessary follow-up measures are not properly implemented.

RELATED POLICY MEASURES

It therefore goes without saying that consistently practical and necessary measures of monetary policy need to be taken in different spheres of the economy for the all-round economic development of the country. They relate to trade, currency, budget, development and administration. Appropriate improvements will have to be effected to make the monetary policy a success. In the existing conditions of Nepal particularly, some groundwork should be initiated within a short time, even if the subsequent steps are gradual to evolve a money market. In this context, the task of expanding Nepalese currency areas throughout the country is essential, and in more recent years this process has been producing the desired effect. Of course, bolder efforts should be made to augment agricultural output and initiate revenue-yielding projects. With greater availability of the required inputs over the coming years, agricultural production should be made to rise and so increase exports. Both in exports and imports, a more liberal policy of diversification will have to be adopted with other countries. On a gradual basis protection to newly-established industries, particularly cottage and small industries, from the outside competition should be offered more favourably and with proper co-ordination. The Government should provide other facilities for reducing the cost of production of such industries. Somehow or other the stock of physical equipment, e.g. cultivable land, physical facilities to increase agricultural output and machines

[12] A. Lewis, *op. cit.* p. 52.

of all kinds, must be made to rise faster than the population (which is rising at the rate of more than 2 per cent per year) so that the average worker may have more and better equipment with which to operate. Along with these, the budgetary policy should be oriented towards pruning down unnecessary expenses, raising revenue increasingly and restraining consumption in the long term. The economic development policy should be based on gradually developing import-substituting industries, increasing agricultural output, placing priorities in planning on production-yielding projects and labour productivity. There should be a more consistent approach to administrative improvement, in view of our open border of more than 600 miles with India in the South.

DIFFICULTY TO DETERMINE REALISTIC RATE

It is so difficult to have correct rate of exchange in a country like Nepal, where all the major indicators of the economic situation are not yet available and render it specifically a tool for economic growth. Still, as Prof. Ganguli has suggested, even "a certain degree of undervaluation is not a bad strategy", when the exchange rate has to be pegged at a lower level, under the IMF system of 'Adjustable Pegging'. First, it would neutralise a foreseeable long-term rise of prices in the over-all context of economic development; secondly, it would operate as an additional stimulus to exports and 'a stronger curb on imports, thus opening up the possibility of a more self-reliant kind of economic development —a consummation in which one would expect a convergence of the enlightened self-interest of both the aid-giver and the aid-receiver'.[13] However, for the attainment of these objectives, even if there is some amount of exchange stability with a proper monetary objective, it is necessary that a broad and co-ordinated set of currency, tax and payments and development policies would have to be achieved during the coming years.

[13] B. N. Ganguli, *Devaluation of the Rupee*, Ranjit Printers, Delhi, 1966, pp. 42-43.

11

CONCLUSIONS AND OUTLOOK

So far, in the general body of this study, we have discussed the problems of fiscal and monetary policies in Nepal, a country which emerged into the international world in all fields only after 1951. The concept of the welfare state also gradually started evolving in the country only after the overthrow of the family rule of the Ranas.

A BRIEF RESUME

In the post-war years, more particularly in the developing countries, the importance of fiscal and monetary policies as tools of economic development was increasingly realised. In Nepal also after 1951, this approach started receiving concerted attention at the policy level, but because of several limitations, substantial progress could not be achieved on the practical plane. It was only after 1956, in certain respects, when the first Five Year Plan was adopted that development in the practical sense started gradually to unfold. Attempts were made to formulate all the related policies. Since then the process has been one of interaction, and of transformation of the present organisational structure of the economy to one in which new modes of activity dominate.

In spite of the fact that foreign aid, either in grants or loans, and foreign investment may open up new opportunities for domestic private capital and thus favourably affect the composition of total investment, the experience of a number of developing countries has shown that the bulk of the total investment in any case should come from their own domestic resources. Fiscal and monetary policies should assure and direct properly all such

resources to the optimum channels of development. They are the most important normative factors determining the size and direction of this investment and indirectly of the extra economic prerequisites of economic advancement. As Professor Alder puts it, the second reason 'for the significance of monetary and fiscal policies is the importance of balance of payments movements to a process of development.' Changes in the flow of in and out payments on current as well as capital account are largely determined by such policies, which may be autonomous in the sense that their objectives are unrelated to balance-of-payments considerations, or induced by movements in the balance of payments generated abroad. Since the balance of payments affects the rate and direction of development, monetary and fiscal policies which bring about changes in the balance of payments are obviously of prime importance in the implementation of development plans.[1]

Against this background we can look at the problems of Nepal, already discussed in the body of the present study. In the absence of necessary statistical data, deeper analysis cannot be possible for the country. Before 1951 the country did not have, as explained above, any fiscal approach and even the budgets which were presented in the early years after 1951 were more or less in the nature of budgetary statements, and they were not very much related to the implementation of the budgets.

It was particularly after 1960 that efforts were made to have some sort of legislative control over the budget, and functional classification of government expenditures started to be adopted gradually. Till 1960, the revenue collected was just enough to meet the traditional type of government expenditure, and development finance was almost completely dependent on foreign aid. It was only after 1960 that efforts to generate savings were initiated and development finance increasingly received top priority in Government policy. The economic classification of the budget attempted after 1960 shows that there have been some obvious improvements – a gradual increase in expenditure on the economic services. For example, from the fiscal year 1962/63, upto the fiscal year 1968/69, government expendi-

[1] John H. Alder, 'Monetary and Fiscal Policies for Development' in *Cahiers de l'Institut Scientifique d'Economie Appliquée*, Paris, June 1956, p. 2.

ture in economic services increased almost three-fold. But it goes without saying that even then, as discussed above, particularly in Chapter 3, almost 80 per cent of the revenue came from traditional sources, the more important being land revenue, customs and excise. This aspect was more explicitly discussed in Chapter 4, with a plea for increasing domestic resources by the gradual introduction of new and direct taxes. The taxation policy of the Government should obviously be formulated not only from the revenue angle but also from principles of general justice and equity. Of course, the greater proportion of indirect taxation is bound to be there in any underdeveloped country for years, in spite of the consistent efforts that have been made to improve tax administration in recent years. Direct taxes, given proper improvement in administration with an element of simplification in keeping with the country's traditions and conditions, can gradually produce sustained improvement in the process of mobilisation of resources for economic development.

In Chapter 5 some analysis was presented to focus the trends which, although the country has hitherto been very much dependent on aid, have resulted from recent reorientation in policy of a number of donor countries in switching over from aid to loans – in some cases even interest free. The problem of debt servicing may naturally assume importance in the years ahead. As explained above, such payments are a charge on domestic real income and savings. Therefore, it was emphasised that, even if for Nepal this will assume importance of any magnitude only from a longer range, right from now efforts should be made to improve the institutional structure of the domestic loans; domestic resources should be mobilised as much as possible and the export sector should be gradually expanded so that, in the years to come, debt servicing particularly in the foreign exchange resources might not be one of the serious constraints in the growth process; the experience of other countries confirms this supposition. At the same time internal loans should be used not for meeting the regular expenditure of the Government but in financing projects which are directly conducive to augmenting production. External assistance, obviously, should not be made a substitute for domestic resources.

It was then pointed out in Chapter 6 that, in the process of mobilisation of savings and maintaining stability with growth

in the economy, fiscal policy would require a basic reorientation. This would have as its main objective the solution of the paramount problem of stepping up the rate of growth by stimulating and assisting production increase and curbing price-rises by countering inflationary pressures. Of course, monetary authorities also have to play an effective role, even within the existing limitations arising from the predominance of the non-monetized sector. The Central Bank, as explained in Chapter 7, can make a significant contribution to development by pursuing a stabilisation policy. The responsibilities of the Central Bank relate not only to its functioning as the lender of last resort, but also to looking after the liquidity position of the economy. It was emphasised that this approach had been increasingly recognised at the policy level by the Government. In fact, along with the monetary authorities, the structure of taxation should be formulated appropriately for accelerating economic development in the context of a mixed economy. Of course, in the given conditions, any structural or institutional changes will have to be instituted quite gradually and on a simplified basis.

In the present stage of Nepal's development, the Central Bank also should play a dynamic role in the overall economic policy of the country in spite of the fact that most of the traditional credit control weapons which have been used in other countries cannot be effectively used here. The money market is still in its infancy and the capital market has yet to evolve in the proper sense in the country. Therefore the Central Bank, instead of being only the controller of monetary matters, should take a dynamic leadership and try to solve the various problems of the Government in the process of fostering the growth not only of banking institutions but also of non-banking financial institutions. In fact, the Rastra Bank can function usefully in the development context by promoting the establishment of new financial institutions, supervising and examining them, helping to train their personnel, and in general to helping them develop efficiency and trustworthiness.

The main functions of commercial banking, which has been in existence for more than thirty years, have yet to be streamlined. As the first commercial bank of the country was started long before the inception of the Central Bank, some of the difficulties in the way of central banking functioning effectively could be

overcome only by having recourse to policies using persuasion to try and bring about better co-ordination among the various institutions in both the money and capital markets, rather than by just using restrictive and other direct methods of control. However, above other things, the Rastra Bank's credit and monetary policy for arresting the rise in prices and curbing credit expansion should be implemented in the most satisfactory way in relation to the commercial banks.

It might also be necessary within certain limits that the financial institutions—both development as well as non-commercial institutions—should be properly taken care of by the Central Bank which would look into them and have some sort of equity participation. In modern times, these institutions are very important for the economic development of the country. Since the exchange rate is equally important for economic growth, and as the rate of exchange in a country effects not only the volume and value of the export and import rate but also internal transactions of the economy, we discussed this topic against the historical background. In this respect the efforts made by the Government as well as the monetary authority to stabilize the Nepalese rupee from a stage of almost virtual collapse to the stage of greater stability and confidence have been quite remarkable, of course in relation to the underdeveloped conditions prevalent in the country.

THE ECONOMIC DEVELOPMENT PLANS

After having discussed these aspects of fiscal and monetary problems so far faced by the country, the stage is now set for offering some sort of conceptual approach, which these policies can contribute to the country's economic development within the context of the overall periodic plans. It will not be irrelevant here first to give some idea of the economic development plans. The first economic development plan, the Five Year Plan, was launched in September 1956. It was attempted without having any statistical data having been formulated for its proper implementation. In the virtual absence of statistical data necessary for planning, no systematic planning techniques could be followed in the formulation of the plan. Since it was more or less a collection of public projects in different fields, with some esti-

mates of their outlays during the plan period, only in some sectors like village development, education and health could achievements be impressive. The overall results proved to be far from satisfactory.

Of course, the framers of the First Five Year Plan had to work under certain handicaps. In particular the administration was quite new to planning; the system of government budgeting had just started, and the statistical information was very scanty and almost completely unreliable. Even so, we have to accept that it was a good experiment in collective thinking and action. It certainly gave the necessary experience, and the self-confidence born of experience, to our planners. The First Plan, broadly, provides a link between the pre-1956 and post-1961 periods; it covered a period when a strategy for economic development started to evolve gradually.

In December 1961, King Mahendra gave the *Panchayat* Democracy to the country. The country started to move forward to create a new society devoid of exploitation and based on class co-ordination. A policy of decentralization has been adopted by phases to inculcate into the *panchayats* the principle of self-reliance and development from below, aimed at the well-being of the common people. The Second Plan (1962-65), launched in July 1962, was more or less a preparatory plan to create the basic pre-conditions for a comprehensive country-wide plan. In general, almost all the outlay envisaged in this plan could be spent, and some progress was also possible in the country's over-all economic development. However, the implementation of the plan could not produce any marked impact on the economic condition of the common people, even if its objective was not limited only to the increase in production. During the plan period, the national income is estimated to have risen by 7 per cent and at the same time population increased by 6 per cent.

The Third Plan, which was launched in July 1965, tries to undertake a nationwide plan with long-term objectives. In addition to the public sector, it also encompasses within its scope the local *Panchayats* and the private sector. Formulated within the range of a 15-year perspective approach, it marks a crucial stage in our economic development. The plan aims at raising the country's national income by almost 19 per cent in five years, with the population assumed to be rising at the rate of 2 per cent

per annum; this will raise per capita income by about 9 per cent. However, the experience of the first four years or so of the Plan period has shown that the rate of population increase has been more than 2 per cent, in fact something like 2.3 per cent, which even if all the targets are achieved satisfactorily would obviously lower the projected growth of *per capita* income. One can see that this is much below the target of annual growth rate set by the United Nations for this Development Decade. At the same time, even this target, on the basis of experience so far, though to be achieved in terms of financial outlay, will not be fulfilled in physical terms or as regards progress towards the completion of the various projects included in the periodic Plan. The basic flaws in plan implementation should not be sought only in planning, but more particularly at the economic policy-making and management levels, and in the degree of efficiency with which this process is carried out.

However, it becomes clear that, in spite of the increasing recognition of the role of fiscal and monetary policies in the process of economic development, – even if such policies are properly geared to the economic development of the country, there have been difficulties to attain the long-term social and economic objectives, as defined in the Constitution of Nepal: i.e. "to promote the welfare of the people by securing and protecting a just social order which brings about harmony in the national life by integrating and consolidating the interests of different classes and professions from a comprehensive national outlook."

MORE EFFECTIVE ROLE

As seen from the foregoing discussion, economic development in Nepal has been planned on the basis of an ever greater contribution from an increasing revenue surplus to the development budget. Revenue over the recent years has increased quite fast, but price increases have eaten up the entire benefits. The country has witnessed sharp monetary expansion in these years, due to certain obviously reasonable factors as well as to certain constraints, and if some effective steps both in the fiscal and monetary fields are not taken, further rapid expansion is bound to occur in the coming years.

While the significant increase in recent years of foreign reserves

with the Rastra Bank can be regarded one of the principal causes of the rapid monetary expansion, the Government's fiscal operations almost all the time were highly contractionary. One should of course note that, apart from earnings from trade, which has been expanding, the increase in the foreign assets arose also from the financing of a substantial portion of the fiscal deficit through the conversion of the big volume of the Indian, US and Chinese cash grants-in-aid for meeting local currency expenses. The recent sharp price increases are also obviously related in an important way to the rapid monetary expansion. At the same time, as explained above, inflationary pressures are to a certain extent inherent in the process of investment for growth, but as Prof. Nurkse suggests, "the way to stop them is not to stop investment. . . . There are other ways: chief among them the powerful *methods* of fiscal policy *and monetary policy*."[2] Adoption of appropriate measures in these areas to prevent any rapid monetary expansion and other constraints should be accorded top priorities, both in fiscal and monetary fields.

FISCAL APPROACH

Such steps would involve both the income and expenditure policy of the Government. In consideration of the large expansionary impact of the Government's fiscal operations so far, despite the contractionary impact of the generating of savings in the revenue parts of the budget for development, it is imperative to place special emphasis on the pursuit of various counter-inflationary measures. Such measures must include, among other things, vigorous efforts to increase government revenue from domestic resources.

It might be worthwhile to suggest certain practical criteria for assessing the potential of major kinds of taxation under given conditions or at different stages of development. Of course, this is not a place to go into details; but, by and large, the assessment of tax potential or possibilities in a country can only be undertaken after a thorough study of the existing system of taxation. Since some study in this respect has already been made, in the

[2] Ragner Nurkse, *Problems of Capital Formation in Underdeveloped Countries*, Oxford, 1958, p. 145. (Author's italics.)

following lines some broad approach will be offered on the perspective basis.

Of course, a look at the various taxes, as given in Chapters 3 and 4, reveals that, as a result of increased taxes, revenue has already increased sharply, rising almost fourfold between fiscal years 1960/61 and 1968/69. Of course, this increase has stemmed partly from the growth in the size of the domestic economy and the rapid increase in the volume of foreign trade. But it has also been the result of deliberate efforts by the Government. Still, domestic revenue, even today, accounts for only a little more than 3 per cent of the GDP, even though total government revenue increased, between fiscal years 1961/62 and 1965/66, more than twofold.[3] It therefore seems imperative that tax reforms in future years should be carried out at a much faster rate.

TABLE 11 : 1
GOVERNMENT REVENUE AS PERCENTAGE OF GDP
(In Millions of Rupees)

	1961/62	1964/65	1965/66
1. Gross Domestic Product	3,748	6,120	7,088
2. Total Government Revenue	91	192	217
3. 2 as percentage of (1)	2.4	3.1	3.1

In the advanced countries, taxation is often used with, as its main purpose, the avoidance of inflation. This might be the approach in a developing country like Nepal also; but one should be aware that, without the strictest economy in the expenditure of funds, which should obviously be generated only for purposes of economic development, mobilisation of additional domestic resources through taxation cannot prove to be anti-inflationary. There should be only a minimal amount of 'permissible rate of growth of public expenditure of the purely consumption type under normal circumstances'. This trend in Nepal has been erratic during recent years. Unless some efforts are made, these expenditures will rise further—apart from normal increase—primarily due to the expansion in administrative machinery and other non-developmental activities. Therefore, more sustained efforts will have to be made to prune down all avoidable expenditure and to achieve further improvements in government administration.

[3] Government revenue as percentage of GDP

We should therefore conclude that public expenditure should be increasingly devoted to developmental activities. Experience so far shows that, although such investment has helped considerably in the improvement of the economy, and has provided better facilities for education, health and other infra-structure activities, it has not yet firmly secured a strong economic base for self-sustained economic growth or helped much in the process of the establishment of a welfare state with class co-ordination, which the Government has accepted as the basic goal of economic development. We have a long way to go towards achieving all the growth objectives, but, given certain changes in our development strategy, these can be made attainable within the shortest possible period.

The capacity to raise taxes is a function of administrative machinery on the one hand, and a conditioner of the economy and its stage of development on the other. In principle, part of the difference in the tax–GNP ratio between developed and underdeveloped countries has to be attributed to their differing tax-raising capacities. As one United Nations report suggests, "The tax system in economies must be designed to be inflation-elastic as well as income-elastic, that is, responsive to changes in money as well as real incomes."[4] Even from this angle, as explained previously, the problem is more one of development, modification and strengthening of particular taxes which might, on the whole, increase the overall elasticity of the revenue system than one of considering or discovering new taxes.

In Nepal, for almost half a century, land revenue could not be geared to the above-mentioned criteria, and of late some changes were made, but still, as mentioned in Chapter 3, it suffers from a number of limitations. It is hoped, of course, that the successful execution of the land reform programme by phases and the completion of the cadastral survey might augment revenue from agriculture. But such generalities alone, as experience has shown, do not solve the main issue, and from a longer range this solution involves the creation of an appropriate atmosphere for economic strength.

Three bold and sweeping economic policy decisions are essential to the creation of any economic strength in our conditions.

[4] United Nations, *Economic Bulletin for Asia and the Far East*, New York, September 1966, p. 42.

First, rents must be lowered significantly and fixed in absolute amount, so that tillers will have a vital stake in increasing output. Increased agricultural production alone will result in larger exports and thus greater prosperity. Secondly, government revenues, particularly land revenue, must be increased considerably to minimize inflationary pressure stemming from deficit financing, to reduce imports of consumer goods (purchased with income from land), and to provide adequate financial support for development activities. Thirdly, land must be purchased from landlords in the overall process of land reform at reasonable prices and sold to tillers. Proceeds from all such sales must be invested in the manufacturing and trade sector so that gradually the required growth will occur.

It might be recapitulated that one of the most striking effects of the land reform programme in Budhabare *Panchayat,* in one of the south-eastern districts, has been the increase in production. In constant prices, the value of production in 1964 was nearly 5 per cent more than before reform in 1963; in 1965 it was 16 per cent more. The increases were due partly to increases in the yield of the main crop, partly to a considerable expansion of the area of land planted with secondary crops.[5]

Of course, large increases in production must also eventually come from additional use of fertilizer, improved seed, and other advanced techniques. But if rents were fixed in absolute amounts all over the country, as was done in the Kathmandu Valley in 1965 at levels equivalent to one-third the present yield (or lower where customary rents have been less than 50 per cent), the response of tillers would be immediate towards increasing production.

Land revenue rates are also inequitable: the amount paid per unit of land varies considerably, and the variation bears very little relation to productivity or land value. Currently, the total land revenue collected is about Rs. 80 million per year. Projecting ahead, collections for central, district and local governments must increase to Rs. 100 million or more per year in fifteen years from now, if development outlays are to be met. However, this outcome will depend much on the rate of increase of agricultural production.

[5] For fuller discussion of this pilot project, see my article 'The Budhabare Pilot Project' in *Khadigramodyog,* Bombay, January 1966, pp. 296-97.

As explained above, the final solution to the attainment of increased land revenue must be based upon cadastral survey records and property values, all incorporated in a sound system of land administration. A few selected districts have already been established on this basis in connection with the decentralization processes. Meanwhile, as an interim arrangement, the yields and area used in fixing ceilings on rent must be relied upon. Using the same yield estimates for both purposes will have the added advantage of increasing objectivity. The landowner's desire for a high yield for rental fixing will be counter-balanced by his desire for a low yield for land revenue purposes.

Reducing rent and raising land revenue will have a sharp impact upon the income of landlords. It is recognized by the landlord class, however, that both steps are inevitable if Nepal is to develop. Today landlords also recognize that they must shift their capital and managerial talent from land to other sectors of the economy. Financial procedures to accomplish this shift, though lacking in the past, are now being emphasised by the Government. Therefore, lower rental ceilings and higher taxes must be accompanied by the creation of an institution, or the modification of existing institutions, in order to facilitate the transfer of capital. Some institutional changes as explained in Chapter 9 will be necessary. For example, the Cooperative Bank was recently transformed into the Agricultural Development Bank.

The Nepal Industrial Development Corporation should continue with its established functions, but as a result of this programme it should also be concerned with such functions as extending credit to former landlords for approved investment purposes, accepting the bonds received from the sale of land as collateral, and utilizing the funds established for land purchase purposes to finance enterprises initiated by landlords. Mortgages will be obtainable on that portion of investment financed by bonds.

Thus even from the fiscal angle, for any serious interest to be aroused among the masses in the *Panchayat* system, the economic interest of the peasants in land and the income from land must be enhanced. As has been found in Budhabare, once the control by the landlord class is broken, the political interest of the peasants

increases considerably. Election to the village *panchayat* becomes possible and thus meaningful and desirable.

But this political awakening, if not matched by additional alternatives for the landlords, might obviously result in class conflict and defeat the very purpose of class co-ordination, which is one of the fundamentals of the *Panchayat* system. The system should be devised in such a way that both the landlord and the tiller class can co-operate without the destructive effect of serious class struggle. In addition, as larger industrial enterprises are established by these processes and corporate boards are elected, opportunities will be opened for men of stature and competence who have not found it possible to remain in positions of political leadership and who, without a challenge of this nature, become frustrated and discontented.

At the same time, it will also be necessary to utilize properly the compulsory savings so successfully collected under the land reform programme. As explained in Chapter 9, certain institutional arrangements have already been made recently towards that end. This can be regarded, as an expert says, as 'a milder alternative to taxation',[6] and it will have to be further developed. The system is different from what is done in Turkey, Brazil, Ghana, India, and Japan. Although our compulsory savings scheme unlike theirs, is basically linked with our land reform measure, Nepal can draw upon their experiences as an alternative to heavy taxes, which will minimise political and economic resistance from the people. For example, in India the Compulsory Deposit Scheme carrying interest applies to income tax assessees only. In Ghana the scheme was completely tied up with the sale of cocoa to a centralised marketing board, 10 per cent of the proceeds of such sales being payable in the form of government long-term bonds.

The success of the process of augmenting customs revenue very much depends on the strengthening of the customs administration. In view of the speedy expansion of various manufactured goods, revenue from excise will also have a tendency to go up quite considerably. Other indirect taxes, such as the sales tax and others, as already discussed in Chapter 4 should have the tendency

[6] J. Bhagawati, *op. cit.*, p. 122.

to expand the yields and in this direction vigorous efforts should be made.

Again, the Government has invested quite substantial amounts in a number of enterprises; some of them are working as government departments, whereas others are autonomous corporations. The investment return to the Government in a number of enterprises such as electricity, railways, ropeways, telephone and wireless, sugar and cigarette factories has been almost negative and they are running at a loss. Therefore, more sustained efforts on a co-ordinated basis will have to be made in this direction to make them both self-supporting and able to yield profits.

Most underdeveloped countries almost neglect taxes on income and wealth in general. In Nepal, of course, income tax was introduced after 1960, and it is now assuming some importance, and in the years ahead this tax should be gradually extended to various new categories of income. Improvements are called for in administration, exemption limits and simplification.

In this respect, as explained in Chapter 4, agricultural income tax, isolating it from the general direct taxation, should be introduced, of course considering the widely scattered distribution of potential assessees. So far agriculturists have been exempted from any payments out of their income from agriculture, but without any adequate justification. If tax on income from agriculture is not imposed, the already existing disparity in the contribution of the rural and urban sectors will be widened still further. With increased investment in the agricultural sector and the expanding price spiral, this sector will be enjoying rising levels of income in future. The principle of levying tax on agricultural income will therefore have to be considered from this angle also.

However, in spite of all efforts, there will inevitably remain a small ratio of direct taxes to total tax revenue for some years, and, based on the experiences of other developing countries, this is bound to accompany underdevelopment. While, in our conditions, we can in theory strictly adhere to the principle of ability to pay, in actual practice for many years to come we will have to rely, under the given conditions, necessarily on indirect taxes.

MONETARY APPROACH

On the monetary side, of course, quite a number of measures

have recently been initiated and they have been fully discussed in the preceding chapters. Certain broad aspects can better be touched upon here. For example, in addition to the various recent steps in the monetary field, it is seen that steady increases in the bank credit to the private sector have been an important expansionary factor in the past years. With the rising activities of trade and commerce in future years also it is quite likely that such credit would rise substantially further; of course one should allow for the normal increase in keeping with the increasing scale of normal domestic economic activity and rate of development of the private sector. Still, the Rastra Bank should be cautious, and see that in view of the expansionary impact of such credit extension, it is necessary to contain its rate of growth within tolerable limits and to direct the bulk of this credit into productive channels. This should form a part of the policy from a longer range. At the same time, along with credit control methods, more active steps should be taken in promoting the expansion of banking institutions and further strengthening the existing credit institutions.

A serious handicap in our economic and financial situation is an inadequately developed—or in Nepal's case we can say a developing phase of the capital market. To compensate, to a certain extent, for this handicap, and to help to develop the capital market in very recent years some kind of financial institutions have been established. Although the commercial banks cannot directly divert their resources towards long-term lending, and thus the part that they can play in the development of the capital market must be limited and largely indirect, the interests of both development banks and commercial banks can best be served by their collaborating with each other as much as possible. They can jointly advance loans to industrial enterprises, the former lending for longer periods and the latter for shorter periods. An almost similar arrangement can be made in respect of investing in debentures. Here also the Nepal Rastra Bank can play a very effective role in promoting the relationship between these two classes of institutions.

During the last few years starting from the fiscal year 1961/62, the foreign exchange budgets have been formulated along with the Governments annual budgets. These foreign exchange estimates give the current general trends of foreign exchange earnings

and expenditures. This approach has increasingly helped in planning to meet increasing import requirements. However, for any sound monetary management, one of the important pre-conditions, along with these would be the regular preparation of monetary surveys. The attention of the monetary authorities has recently been turned to this aspect and some efforts are under way. Still we could suggest that, in close collaboration with the relevant agencies of the Government and others, the Nepal Rastra Bank should prepare annually monetary budgeting dealing with all major aspects of monetary management, in particular analysing current developments affecting money supply and the possible measures of reforms. The International Monetary Fund in recent years has been suggesting to its member countries the regular study of such a prospective monetary situation to help the authorities concerned in formulating appropriate policies aimed at controlling the rate of monetary expansion.

NEED FOR PROJECTION

However inadequate the statistical data may be regarding a country, it is always helpful and even necessary to have some estimates of future projections based on such data with regard to tax yields, credit expansion, resources for development and other factors. Of course, in the existing conditions of Nepal, both in fiscal and monetary fields, one would only be risking a serious margin of error if one made any such estimates for a period longer than one or two fiscal years. One need not therefore expect in long term estimates a degree of accuracy approaching that of the budget estimates. Yes, as Nepal has embarked upon periodic plans, even on the basis of the inadequate statistical data available, long-term projections cannot be dispensed with; and periodic revisions should be made from time to time.

In the last analysis we should not forget that, whatever the scope of the fiscal and monetary policies, both of them will have to be for a system of planned disequilibrium and planned disproportionalities between income and expenditure investment and savings. Although the techniques in operation are different with the two policies, the objectives are almost synonymous in the sense that both have as objectives the rapid economic progress of the country. More comprehensive and systematic planning is required

for the development of the financial structure needed for the economic development of the country according to the pace and pattern set for it. Needless to emphasise, the policy of controlled expansion pursued by the Rastra Bank as the central co-ordinating monetary authority can succeed only if monetary improvements are satisfactorily integrated with suitable fiscal and other economic policies. For that reason, there should be greater harmony of interests between these two policies. Our extremely low overall rate of development, in the context of the major constraints so far on further economic progress, can only thus be overcome, and the rate of development can be stepped up only by bringing about much closer coordination between the two areas. For the successful working of fiscal policy, monetary policy should be geared in such a manner that it would not counteract fiscal measures undertaken by the Government for development purposes; and in some cases, it is even *vice versa*.

APPENDIX

A NOTE ON NATIONAL INCOME ESTIMATES

THE end-result of economic activity is the production of goods and services and the distribution of these goods and services to the members of the community. To achieve this basic objective it is imperative to know all the indicators of national income and output. In fact, national income data serve as an important tool for properly studying and analysing the productive resources of a nation and the general standard of living of the people. Generally speaking, gross national product consists of the total volume of goods and services produced during a period of time as a result of combined activities organised by the community.

In Nepal no serious attempt could be made earlier to calculate national income due to the dearth of statistics. The first attempt was made by Prof. W. O. Thweatt, an economist in the Ford Foundation, for the year 1954. For 1954, he estimated the national income of Nepal at Rs. 2,582 million, and *per capita* income according to the estimate stood at $ 40 (Rs 304). He derived these figures simply by comparing the *per capita* income of Pakistan, which he guessed to be almost similar to Nepal's with respect to economic development during the period. In his own words, "the *per capita* figure in Nepal is but a fraction of Pakistan's *per capita* income."[1] Prof. Thweatt's estimate was almost an *ad hoc* approach, which, no doubt, has helped to create some basis for further investigation. He himself called it only a 'rough approximation'.

It was in 1963 that the first attempt was made by the Economic Planning Ministry to calculate the gross domestic product for the fiscal year 1961/62, and the second attempt was made in the year 1965 to estimate the gross domestic product for the year 1964/65.

[1] William O. Thweatt, *Elasticity and the Growth Equation*, Asia, Bombay, 1961, p. 51.

Since then computation of national income data is being made almost regularly. By dividing the economy into twelve sectors, as given below, gross domestic product was calculated at market price.

TABLE 1

GROSS DOMESTIC PRODUCT AT MARKET PRICE FOR THE YEARS 1961/62, 1964/65 AND 1965/66 BY INDUSTRIAL ORIGIN

(In Millions of Rupees)

	1961/62	1964/65	1965/66
1. Agriculture	2,393	3,915	4,697
2. Mining	17	20	20
3. Manufacturing	32	83	98
4. Construction	141	123	143
5. Transport	34	91	93
6. Cottage Industries	425	587	704
7. Financial Institutions	22	69	80
8. Ownership of Dwellings	338	676	689
9. Public Administration and Defence	77	82	107
10. Public utilities	1	4	5
11. Wholesale and Retail Trade	215	300	281
12. Services	50	170	177
	3,748	6,120	7,088

However rough and ready the basis may be, computation of national income data has been of considerable help to the economists and policy framers. Of course, there has been some time-lag, which will have to be improved in future as much as possible. This is not a relevant place to discuss the full implications of the above figures in different years, but from the discussion in the general body of the present study, it is quite obvious that Nepal's rate of economic growth has been one of the lowest in the world, even if she launched economic development programmes very late. For the economy to move forward from a transitional stage of underdevelopment gradually to the stage of self-sustaining economic growth over the years, a closer and more effective role for fiscal and monetary policy is necessary, and this would presuppose a much closer co-ordination between these two fields.

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